FE

FEDERAL INCOME TAX

War-Profits and Excess-Profits Taxes

INCLUDING

Stamp Taxes, Capital Stock Tax, Tax on Employment of Child Labor

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PREFACE

A radical change in our system of income and excess-profits taxation seems imminent—for two reasons.

The complexities of the present system involve too much administrative labor—simplification is necessary if the tax is to be collected promptly and at low cost. Attention should, and will be, directed towards the solution of this problem. There is also a widespread conviction that the tax burden must be lightened. The excess-profits tax is the particular subject of attack, but it is difficult to see how this tax can be completely abandoned for some time to come without increasing the income tax rates. The solution may perhaps be found in the adoption of some new form of income tax on corporate incomes—such, for instance, as taxing the undistributed incomes of corporations at very heavy rates (in order to increase the distribution of dividends) or a graduated tax, based on invested capital, with perhaps a single division of income to relieve the corporations with low, fixed incomes of too heavy a burden and to tax all others at the same rate.

In the meantime development of the present law goes on apace. Many new regulations, rulings and decisions have appeared and are noted and commented upon in this the third edition of the author's work. Old rulings, and practice under the former statutes, have been retained and are stated in the foot notes or in separate paragraphs so that the book may be useful in answering questions arising on examination of old returns as well as in preparing new ones.

The author's thanks are again extended to the many friends who have given him helpful suggestions and criticism, and particularly to Mr. Randolph E. Paul, of the New York Bar, and Mr. H. B. Spaulding for their assistance in preparing the manuscript. The author also acknowledges with gratitude the valuable help received from Ross W. Lynn, Esq., of New York and Thomas G. Deering, Esq., of Chicago. The Income Tax Service and The War Tax Service issued by the Corporation Trust Company of New York

have again been referred to as sources of information on Treasury Department rulings and regulations. These services are so generally recognized as the standard reporters that no explanation need be given for their use. They are cited "I. T. S." and "W. T. S.," respectively, in the footnotes.

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FEDERAL INCOME TAX

CHAPTER I

INTRODUCTION [1]

The Federal Income Tax is now imposed by Title II [2] and the Excess-Profits tax by Title III of the comprehensive Revenue Act of 1918.[3] This Act (referred to in this book as the Revenue Act of 1918, the 1918 Law or the present law) was introduced into Congress during the war with Germany, and many of its provisions are definitely a reflection of the exigencies of the times. It provides for the year 1919 and subsequent years by reducing the original rates of normal tax in the case of individuals and income tax in the case of corporations, and in addition to reducing the excess-profits tax rate, it practically abrogates the war-profits tax after the year 1918. The rates of tax are still higher than those imposed by any preceding law. The taxes imposed by the 1918 Law are stated to be in lieu of those imposed by preceding laws, and the 1917 and 1916 laws are repealed, except so far as they remain in force for the assessment and collection of all taxes which have accrued thereunder and for the imposition and collection of penalties with respect thereto. The law expressly provides that no taxes shall be collected under the 1916 or 1917 Laws for any period after December 31, 1917, except in the case of the Philippines and Porto Rico. The 1918 Revenue

1 The purpose of this chapter is to describe briefly the salient provisions and requirements of the law and the system by which it is administered, so that the reader may obtain a general understanding of the subject before the various provisions are discussed in detail.

2 Title I of the same act contains definitions applicable to the titles following, and must be consulted in connection with Title II.

3 The act is entitled "An Act to provide revenue, and for other purposes," and may be cited as the "Revenue Act of 1918." (See Section 1404).

Bill was first introduced in Congress on May 27, 1918, but was not finally enacted until February 24, 1919, after many changes and the substantial modification of many of its provisions. The 1918 Law was drafted with greater care than any preceding income tax law, and is presented in a form which, it may be hoped, will not be changed materially by future enactments. Notwithstanding the improvement in the form and language of the statute the 1918 Law is more complicated than any preceding statute by reason of many exceptional provisions, designed to meet the extraordinary situation resulting from the abnormal incomes, abnormal losses and abnormal tax rates of the period which embraced the closing of the war and the transition of business from a war to a peace basis.

Preceding Federal Laws. In 1917 the Federal Income Tax was imposed by two statutes, prescribing separate and different rates, one additional to the other. The Act of September 8, 1916 (referred to in this book as the 1916 Law), imposed a tax at comparatively low rates and with comparatively high exemptions. It was amended in many respects by the Act of October 3, 1917 (referred to in this book as the 1917 Law), but remained in force as a separate law imposing a general income tax in contradistinction to the "war income tax" at higher rates and with lower exemptions, which was also included in the Act of October 3, 1917. The 1917 War Income Tax Law contained no administrative provisions, but provided that the tax it imposed should be computed, levied, assessed, collected, and paid upon the same basis and in the same manner as similar taxes imposed by the 1916 Law. Generally speaking, both laws were administered as one, and only one annual return of net income was required from each taxpayer, on the basis of which both taxes were assessed. The 1916 Law was preceded by the Act of October 3, 1913 (referred to in this book as the 1913 Law). This law remained in force without change or amendment up to September 8, 1916, when the 1916 Law was enacted and made retroactive to January 1, 1916. The 1913 Law was the first general income tax law after the adoption of the Constitutional Amendment permitting the imposition of an income tax without apportionment and without regard to any census or enumeration, but there was in effect in this country, from August 5, 1909, to January 1, 1913, a corporation excise tax act (referred to in this book as the 1909 Law), which im-

posed a special excise tax on corporations with respect to the carrying on or doing of business by such corporations. Though the 1909 Law was not intended to be and was not in any proper sense an income tax law,[4] the tax was measured by the net income of corporations, and the language of the subsequent income tax laws is in many instances either identical or very similar. To that extent decisions and rulings under the 1909 Law throw light on the construction of the present law and are referred to for that purpose in this book. Rulings and decisions under the 1913, 1916, and 1917 Laws are referred to in this book so far as, in the opinion of the author, they may be of present value to taxpayers in general.[5]

During and after the Civil War income taxes were imposed by the Act of July 1, 1862, the Act of June 30, 1864, and the joint resolution of July 4, 1864, the Act of March 3, 1865, amending the Act of June 30, 1864, the Act of March 2, 1867, and the Act of July 14, 1870. In 1871 the last of the Civil War income tax acts expired and was not re-enacted. No further attempt was made to collect income taxes by the Federal Government until the Act of August 28, 1894, which was held unconstitutional on the ground that incomes from real property could not be taxed without apportionment.[6] As

[4] See language of Justice Pitney in Stratton's Independence v. Howbert, 231 U. S. 399.

[5] Rulings and decisions under all the prior laws should be used with caution in construing the 1918 Law, as this law contains many new features and changes the old law radically in many respects.

[6] Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601. With regard to the history of the income tax, the Wisconsin Court in State v. Frear, 134 N. W. 673, 135 N. W. 164, said in 1912: "It may be well to note, however, that income taxation is no new and untried experiment in the field of taxation. It has been in use in various forms, and generally with the progressive feature, by many of the civilized governments of the world for decades, which in some instances run into centuries. It has been used at various times by nearly or quite twenty of our own states, and is now in use in several of them. It was used for a brief period by the government of the United States, and is now in successful operation in practically all of the great nations of the civilized world except the United States. The fundamental idea upon which its champions rest their argument in its favor is that taxation should logically be imposed according to *ability to pay,* rather than upon the mere *possession of property,* which for various reasons may produce no revenue to the owner."

a result, the Sixteenth Amendment expressly authorized the imposition of a tax on income from all sources without apportionment and without regard to any census or enumeration.

Administration of the Laws. The duty of administering the income tax laws and collecting income taxes is imposed on the Bureau of Internal Revenue, which is a part of the Federal Treasury Department. The bureau is under the charge of the Commissioner of Internal Revenue (referred to in this book as the Commissioner), who under the direction of the Secretary of the Treasury (referred to in this book as the Secretary) has general superintendence of the assessment and collection of all duties and taxes imposed by any law providing for internal revenue.[7] The states and territories are divided into some sixty-four collection districts,[8] each under the charge of a collector of internal revenue, with one or more deputy collectors. Returns of net income are filed with the local collector and the tax is paid to him, although assessments are made by the Commissioner at Washington. The Commissioner, through his revenue agents or inspectors has supervisory power over, and authority to investigate, all accounts, lists or returns required to be made by persons liable to tax,[9] may examine the books of such taxpayers, and on refusal to allow an examination, may summon any person or corporation to produce his or its books and to appear before him to give testimony or answer interrogatories under oath respecting the matter.[10] Collectors and the Commissioner may make returns for taxpayers from their own knowledge and from such information as they can obtain through testimony or otherwise in cases where the taxpayer fails to file a return or makes

[7] R. S., § 321.

[8] As a rule the boundaries of collection districts coincide with the boundaries of the states, but sometimes one collection district embraces two or three states, or one state is divided into two or more collection districts. Districts within a state are designated by number, as the first and sixth districts of California, being the two districts of that state. The lack of sequence in numbering is due to the consolidation of districts from time to time since the period immediately following the Civil War, when the country was divided into the maximum number of districts.

[9] Revenue Act of 1918, § 1305. See also U. S. v. Hodson, 14 Int. Rev. Rec. 100; 10 Wall. 395, 406.

[10] R. S. § 3173, as amended by the Revenue Act of 1918.

a false or fraudulent return.[11] Appeals from decisions of collectors may be taken to the Commissioner.[12]

REVENUE AGENTS AND INSPECTORS. The duties of revenue agents and inspectors are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make the returns required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns for the purpose of ascertaining and reporting as to whether or not the law has been complied with, when so ordered by the agent in charge of the division to which they are assigned, who in turn reports to the Commissioner, and to the collector of the proper district. In the discharge of their official duties officers of this class are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint.[13]

Advisory Tax Board and Committee on Review and Appeal. Because of the large nnmber of difficult cases arising under the great scope of the Internal Revenue Laws, and the amount of revenue involved in the collection of the taxes imposed thereby and to assure fair and adequate consideration of every case arising under such laws, an "Advisory Tax Board" was created by the 1918 Law. The Advisory Tax Board consisted of not more than six[14] members appointed by the Commissioner with the approval of the Secretary, and was to remain in existence until February 24, 1921, unless abolished before that time by the Commissioner with the approval of the Secretary. This Board was dissolved on October 1, 1919, and its work taken over by a "Committee on Review and Appeal."[15] The Commissioner may, and on the request of any taxpayer directly interested must, submit to this

11 R. S. § 3176, as amended by the Revenue Act of 1918.

12 See Chapter 37.

13 T. D. 1932.

14 Five memberships on the Advisory Tax Board were announced on March 14, 1919. The sixth membership was reserved as a roving commission for experts who will be called from time to time from various industries. (I. T. S. 1919, ¶ 3249.)

15 Announcement by the Commissioner of Internal Revenue dated September 27, 1919; I. T. S. 1919, ¶ 3587.

Committee any question relating to the interpretation or administration of the Internal Revenue Laws. The Committee reports its findings and recommendations to the Commissioner. The Committee has power to summon witnesses, take testimony, administer oaths, and require any person to produce books, papers, documents, or other data relating to any matter under investigation. Any member may sign subpoenas and members and employees of the Bureau of Internal Revenue designated to assist the Committee, when authorized, may administer oaths, examine witnesses, take testimony, and receive evidence.[16] Particular attention will be given to problems presenting differences of opinion existing between the taxpayers and the Bureau. Such differences occur not only with individuals, but also with groups and even with classes of industry. Formal hearings will be given to taxpayers in every case where the facts warrant. The Commissioner has already announced his policy "to employ every means available so that the scales of justice may be held evenly in deciding each case." The Committee will be called upon to decide questions involving general aspects of taxation and the differentiation of economic activities, accounting, forms of organization, trade customs, industrial management, legal procedure and administration. Special studies will be made of such matters so far as they affect federal taxation.[17]

Rulings and Regulations. The Commissioner, with the approval of the Secretary, is expressly authorized to make all needful rules and regulations for the enforcement of the provisions of the revenue laws.[18] Such rules and regulations are published under the caption of "Treasury Decisions" and are numbered serially for the purpose of reference.[19] At intervals large compilations of rulings and regulations are published by the Bureau of Internal Revenue and these are designated as "Regulations" and given a serial number.[20] As a general rule, it may be said

16 Revenue Act of 1918, § 1301.

17 See I. T. S. 1919, ¶ 3251.

18 Revenue Act of 1918, § 1309.

19 Treasury decisions contain rulings on all subjects over which the Bureau of Internal Revenue has jurisdiction. Those relating to the income tax are therefore not numbered in sequence. Reference to treasury decisions is usually made by abbreviation, thus "T. D. 2476."

20 The last general compilation of rulings on the income tax is known as

that these regulations have the force and effect of law and are as binding as if incorporated in the statute.[21] But they must be in execution of or supplementary to, and not in conflict with, the provisions of the statute pursuant to which they are issued.[22] It is also held that they must be reasonable and a regulation defeating the purpose or enlarging the scope of the statute is invalid.[23] In determining whether a regulation is consistent with law the courts apply the same rule of decision which controls when an act of Congress is assailed as not being within the powers conferred upon Congress by the Constitution, and it will not be held invalid unless it is plainly and palpably inconsistent with law and entirely inappropriate to the end specified in the Act of Congress.[24] The promulgation of a regulation does not estop the Treasury Department from reassessing the tax on a different basis if the courts hold that the regulation was not authorized by the law.[25] Regulations are admissible in evidence when pertinent to the issues, and as the courts take judicial notice of them as public records, it is unnecessary to introduce them formally in evidence.[26] What has been said of regulations applies only to the express terms of the regulation itself regularly promulgated and not to printed headings on a form additional to the express terms.[27] In addition to rulings and regulations the Department issues so-called mimeograph letters to collectors, more or less confidential in their character and not intended

Regulations No. 45, dated April 17, 1919. All previous rulings and decisions or parts thereof, including Regulations 45 (Preliminary Edition) Regulations No. 33, issued January 5, 1914, and Regulations No. 33, Revised, issued February 4, 1918, which are in conflict with those contained in this revised compilation are thereby superseded and revoked, but any former rulings, not inconsistent, remain in effect.

21 Ex parte Kollock, 165 U. S. 526; U. S. v. Eaton, 144 U. S. 677; Stegall v. Thurman, 175 Fed. 813.

22 Edwards v. Keith, 231 Fed. 110.

23 Campbell v. U. S., 107 U. S. 410; U. S. v. Two Hundred Barrels of Whiskey, 95 U. S. 571; Morrill v. Jones, 106 U. S. 467; U. S. v. Three Barrels, 77 Fed. 963.

24 Boske v. Comingore, 177 U. S. 459.

25 Goldfield Consolidated Mines Co. v. Scott, 247 U. S. 126; N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576.

26 Sprinkle v. U. S., 141 Fed. 811; Caha v. U. S., 152 U. S. 211; Dominici v. U. S., 72 Fed. 46; Wilkins v. U. S., 96 Fed. 837.

27 U. S. v. Lamson, 162 Fed. 165.

for general publication. Frequently such letters throw light on the administration of the law and such mimeograph letters as have been made public are referred to in this book. Mimeograph letters are addressed to collectors only and not also "to others concerned" as are the official treasury decisions, and do not affect or give notice to taxpayers. Similarly, instructions to a particular collector do not affect collectors as a class.[28]

INFORMAL RULINGS. It was previously the practice of the Bureau of Internal Revenue to make informal rulings in the form of letters, at the request of taxpayers, upon abstract propositions involving questions of tax liability. The Bureau will no longer answer such inquiries except under the following circumstances: (1) The transaction must be completed and not merely a proposition or plan, (2) the complete facts relating to the transaction together with abstracts from contracts or other documents necessary to present the complete facts must be submitted (3) the names of all the real parties interested (not "dummies" used in a transaction) must be stated regardless of who presents the question, whether attorney, accountant, tax service, or other representative.[29]

RETROACTIVE EFFECT OF RULINGS. Treasury Department decisions promulgating rulings of the Internal Revenue Bureau become effective upon the date of approval unless otherwise stated therein. Cases previously adjusted in contravention of law as pronounced in such decisions, are subject to readjustment in accordance with the decisions.[30] Generally speaking, any ruling or regulation made by the Treasury Department supersedes all prior rulings and regulations and is retroactive to the time the law was enacted, since a ruling or regulation is merely an interpretation of the meaning of the law, and in theory the meaning has been the same from the beginning. The Treasury Department recognizes, however, that in some instances it would be unjust or impracticable to reopen returns, adjustments or assessments which have been made in accordance with previous rulings, and where such rulings are superseded, an express limitation is

[28] Landram v. U. S., 16 Ct. Cls. 74.

[29] Statement by the Bureau of Internal Revenue dated August 26, 1919, I. T. S. 1919, ¶ 3538.

[30] Reg. 33 Rev., Art. 38.

made in the superseding ruling or regulation as to the retroactive effect thereof.[31]

United States. The term "United States" where used in a geographical sense in the law includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.[32]

Possessions of the United States. The Revenue Act of 1918 does not extend to possessions of the United States. An individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, is taxable only on income derived from sources within the United States. In such cases the tax is computed and paid in the same manner and subject to the same conditions as in the case of non-resident aliens.[33] The term "possessions of the United States" includes, among others, Porto Rico, the Philippines and the Virgin Islands.[34]

Porto Rico and the Philippines. The Revenue Act of 1918 does not apply to Porto Rico and the Philippines, and the citizens thereof, who are not residents of the United States, are taxable only on income derived from sources within the United States. A local income tax, however, is provided for these possessions by making the Revenue Act of 1916, as amended, apply to them. Returns are required to be made and taxes to be paid to these respective possessions, under Title I of the Revenue Act of 1916, by (1) every individual who is a citizen or resident thereof or derives income from sources therein and (2) every corporation created or organized therein or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippines, but derives income from sources therein is taxed as a non-resident alien, and a corporation created or organized outside of Porto Rico or the Philippines and deriving income from sources therein is taxed as a foreign corporation.[35] Under the present law, therefore, a citizen or resident

31 See last paragraph of mimeograph letter to collectors dated August 14, 1914; I. T. S. 1918, ¶¶ 392 and 1344; also the last paragraph of T. D. 2313 and T. D. 2317.

32 Revenue Act of 1918, § 1.

33 Revenue Act of 1918, § 260.

34 Reg. 45, Art. 382.

35 Revenue Act of 1918, § 261. A corporation or individual whose return under the 1916 Law was specifically required to be filed with the collector of

of the United States, and a domestic corporation in the United States, is primarily liable to pay a tax in Porto Rico or the Philippines on income derived therefrom and also a tax to the United States on the same income, but is entitled to deduct the amount of income tax paid to those possessions from the amount due on the entire net income to the United States.[36] Under the 1916 Law Porto Rico and the Philippines were treated as a part of the United States and only one tax was imposed on the income of taxpayers residing therein and deriving income from the states and territories, or vice versa.[37] Under the 1916 Law and also under the present law the Porto Rican or Philippine Legislature has power by due enactment to amend, alter, modify or repeal the income tax laws in force in its jurisdiction.[38]

Gross Income. Gross income is defined in the law to include income, gains or profits of all kinds except those enumerated as exempt from taxation. A more complete definition will be found in a subsequent chapter.[39]

Net Income. Net income is defined as gross income less the deductions allowed by the law, as is more fully stated in a subsequent chapter.[40] The Revenue Act of 1918 for the first time requires net income to be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in accordance with the method of accounting employed in keeping the books of such taxpayer. If no method of accounting has been employed or if the method employed does not clearly reflect the income, the computation is to be made upon

one of the districts of the continental United States was not taxable in Porto Rico or the Philippines, although a portion of the income received might be derived from business carried on in one or both of those jurisdictions. Although the law provided that income collected in those jurisdictions "shall accrue intact to the general governments thereof," this was held to refer only to the tax legally assessable therein, and not to alter the general rule that all of the tax should be paid in the district in which the taxpayer resided or had his or its principal place of business.

36 Revenue Act of 1918, § 238. Reg. 45, Arts. 1132 and 1133.

37 Letter from Treasury Department dated April 4, 1917.

38 Revenue Act of 1918, § 260. See also Revenue Act of 1917, § 5. Since this power exists, it is not safe to assume that the income tax laws in Porto Rico and the Philippines are identical with the Revenue Act of 1916.

39 See Chapter 14.

40 See Chapter 14.

such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.[41]

Deductions and Credits. The law specifies that certain deductions may be made from gross income in ascertaining the net income of the taxpayer. "Deductions" reduce income for all purposes. "Credits" do not reduce net income for all purposes, but reduce the net income of an individual for the purpose of the normal tax and not the surtax, or, in the case of a corporation, reduce net income for the purpose of the income tax and not the excess-profits tax. Another form of credit provided by the law may be applied directly against the tax and not against the net income. These distinctions are more fully stated and explained in subsequent chapters.

Reporting Net Income. Taxpayers are required to file annually a return showing the amount of gross income received, the deductions, credits and exemptions claimed and the net income upon which the tax is to be imposed. This return is filed in the collection district in which the taxpayer resides or has his principal place of business. Non-residents having no place of business in this country file their returns with the Collector of Internal Revenue at Baltimore, Maryland.[42] The returns are required to be filed on or before March 15, if the report is made for the preceding calendar year. If made for a fiscal year, the returns are required to be filed on or before the 15th day of the third month following the close of the fiscal year. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists.[43] Under the 1918 Law both individuals and corporations are required to file their returns for their fiscal years instead of for the calendar year if they keep books of account which are regularly closed each year at the end of some month other than December. One important change made by the 1918 Law is that partnerships are required to file annual returns showing their net income although they are not subject to tax as partnerships.[44]

41 Revenue Act of 1918, § 212.

42 Revenue Act of 1918, § 227 and § 241. This dictrict is the one in which Washington, the national capital, is located.

43 Revenue Act of 1918, § 227 and § 241.

44 Revenue Act of 1918, § 224. See Chapter 8.

Record to Be Kept. Every individual, partnership or corporation liable to any tax imposed by the internal revenue laws of the United States, or for the collection thereof, is required to keep such records, to render such statements and returns under oath, and to comply with such regulations as shall be prescribed by the Commissioner. The Commissioner may also examine any books, papers, records or memoranda of a taxpayer.[45]

Individuals. Ordinarily, no person whose net income is less than $1,000 in any calendar year is required to file a return for that year, but the Commissioner may require any person, whether liable to tax or not, to file returns of income or such statements as he may deem sufficient to show whether or not such person is liable to tax.[46] Unmarried persons and married persons not living with husband or wife and receiving $1,000 or more net income during the calendar year, and married persons living with husband or wife and receiving $2,000 or more net income during the same period, are required to file annual returns. Minors are now required to file returns if they have received the mininum amount of income specified in the law. Prior to 1918 returns were required only of persons of lawful age.[47]

PERSONAL EXEMPTION. The personal exemption or credit is an arbitrary amount of net income on which residents and citizens (in some cases non-resident aliens) are not taxed.[48] It may be said to be an amount allowed for personal or family expenses, the actual amount of such expenses not being deductible in ascertaining net income. The amount of the personal exemption allowed to an individual depends upon his status. Married persons living together and heads of families, whether married or not, are entitled to an exemption of $2,000. Others are entitled to $1,000. An additional exemption of $200 is allowed to any taxpayer, whether single or married or head of family, for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.[49] A non-resident alien

[45] Revenue Act of 1918, § 1305; Reg. 45, Art. 1711; Reg. 33 Rev., Art. 50.

[46] Revenue Act of 1918, § 1305.

[47] See Chapter 34 for further discussion of this subject.

[48] Revenue Act of 1918, § 216 and § 217.

[49] Revenue Act of 1918, § 216. The exemption of $200 was formerly limited

is entitled to claim these exemptions to the same extent as a citizen or resident unless he is a citizen or subject of a country which imposes an income tax and does not allow a similar exemption or credit to citizens of the United States not residing in such country. The personal exemption may be deducted only in computing the normal tax.[50] The 1918 Law provides that all corporations shall be entitled to an exemption of $2,000.[51]

Normal Tax. The normal tax is a tax imposed upon all the net income of an individual in excess of (a) dividends received from taxable corporations; (b) interest upon bonds and other obligations of the United States issued after September 1, 1917; (c) interest upon bonds issued by the War Finance Corporation; (d) the personal exemption and (e) the exemption for dependent persons.[52] For the year 1919 and subsequent years the rate of normal tax in the case of citizens and residents of the United States is 4% on the first $4,000 of income subject to normal tax and 8% on the remainder; and in the case of non-resident aliens 8% on all net income from sources within the United States subject to normal tax.[53]

to cases of *children* dependent upon the taxpayer, and is now extended to cases where other persons are dependent, as stated in the text.

50 For a further discussion of the personal exemption, see Chapter 31.

51 Prior to the 1918 law corporations have not been allowed an exemption similar to the personal exemption allowed to individuals.

52 Revenue Act of 1918, § 216. The distinction made between incomes subject to normal tax and incomes subject to surtax is artificial and necessary only for the purpose of granting certain partial exemptions or taxing various kinds of income at different rates. The distinction between normal taxes and surtax seems to have originated in England where the income tax was first imposed at a proportional rate on all income and later graduated rates were applied to incomes over a minimum limit. One reason for distinguishing between normal taxes and surtaxes under our 1913 Law lay in the fact that the statute provided for withholding at the source of the normal tax, as does the English Law. Under the 1913 Law and the 1916 Law the normal tax was the rate which applied to corporations and individuals alike but under the present law this characteristic is destroyed since the normal tax is also a graduated tax. The law will no doubt always retain the distinction between normal and surtaxes since bonds of the United States are issued exempt from "normal tax," an exemption which, by the way is uncertain and precarious since it is within the power of Congress to reduce the normal tax at any time to a minimum and thereby practically destroy the tax exemption or raise the normal tax as is done by the present law in order to increase the exemption.

53 Revenue Act of 1918, § 210. For the year 1918 the rate of normal tax

Surtax. A surtax (sometimes called "supertax" or "additional tax") is imposed upon the entire net income of individuals in excess of $5,000 without deducting the personal exemption and including dividends and interest on United States obligations, issued after September 1, 1917, and bonds of the War Finance Corporation. The surtaxes are at a series of graduated rates the first of which is imposed on that part of the net income which exceeds $5,000 and does not exceed $6,000. Each additional $2,000 of net income is subject to a higher rate of tax than the preceding one up to and including $100,000, and thereafter the surtax is increased at less frequent intervals on income up to $1,000,000, the final rate being 65% on the amount by which the net income exceeds $1,000,000.[54]

Corporation Tax. The income tax imposed on corporations is at the rate of 10%.[55] This rate might be said to measure the normal tax imposed on corporations in contradistinction to the graduated excess-profits tax which is also imposed on corporations. For the purpose of the income tax the net income which is subject to the excess-profits taxes is reduced by deducting therefrom certain credits consisting of (a) interest on the bonds and obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation; (b) the amount of any excess-profits tax imposed on the net income for the same taxable year; and (c) in the case of a domestic corporation the sum of $2,000.[56] Certain kinds of corporations not organized for profit, both domestic and foreign, are exempt from this tax.[57]

Personal Service Corporations. The 1918 Law recognizes a new class of corporations—those whose income is due primarily to the activities of the principal owners or stockholders who are

in the case of citizens and residents of the United States was 6% on the first $4,000 of income subject to normal tax and 12% on the remainder. Nonresident aliens were subject to a normal tax at the rate of 12% on all of the net income subject to normal tax received from all sources in the United States.

54 Revenue Act of 1918, § 211. See Chapter 2 for a schedule of rates of this tax.

55 This rate was 12% for the year 1918.

56 Revenue Act of 1918, § 230 and § 236. This subject is more fully discussed in Chapter 10.

57 See Chapter 13 for list of exempt corporations.

themselves regularly engaged in the active conduct of the affairs of the corporation and in which the capital invested is not a material income-producing factor. Such corporations are recognized as being taxable in the same manner as partnerships; that is, the corporation is required to pay no tax but the stockholders are required to include in their personal returns their distributive shares of all the profits of such corporations whether distributed or not. Personal service corporations are composed, for instance, of professional men or agents who have adopted the corporate form merely as an incidental convenience. The law expressly provides that no foreign corporation shall be considered to be a personal service corporation, nor shall any corporation be so considered if 50% of its gross income consists either of gains, profits or income derived from trading as a principal or of gains, profits, commissions or other income, derived from Government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[58]

Partnerships. A partnership itself is not taxable, but the members of the partnership are required to report their distributive shares of the partnership income, whether such income is actually distributed or not. The present law expressly states that where the fiscal year of a partnership ends within a calendar year the partner shall be taxed at the rates for the preceding calendar year on that proportion of his share of the partnership's net income equal to the proportion which the part of the fiscal year falling within such calendar year bears to the full fiscal year; and the rates for the calendar year during which such fiscal year ends shall apply to the remainder. For instance, if the partnership fiscal year ends June 30, 1919, the partner will be taxed at the 1918 rates on one half of his net income from the partnership and at the 1919 rates on the other half.[59] Thus, if his share of partnership profits were $40,000, the first $20,000 would be taxable at the 1919 normal tax rates and the second $20,000 at the 1918 normal tax rate applying to incomes over $20,000.[60] The surtax rates will be applied to the entire $40,000, without distinc-

[58] Revenue Act of 1918, § 200. For further discussion of this subject see Chapter 9 and as to the excess-profits tax see Chapter 43.

[59] Revenue Act of 1918, § 205 and § 218.

[60] Id. § 206.

tion, since those rates are the same in 1918 and 1919. All partnerships are required to file annual returns of income for the purpose of showing the amount of net income distributable to each partner.[61]

Collection of the Tax at the Source. Collection at the source, deduction at the source, withholding at the source and stoppage at the source, are synonymous terms meaning that the one paying income to another deducts or withholds an amount equal to the tax on the sum so paid and turns it over to the Government to the credit of the one against whom it is withheld. This method is used in order to facilitate the collection and to prevent evasion of the tax. Under the 1913 Law, and the 1916 Law during the year 1916, the normal tax was withheld on payments to individuals, whether citizens, residents or non-resident aliens. Under the 1916 Law, as amended by the 1917 Law, the tax was not withheld on payments of income to citizens and residents (except in the case of bonds containing tax-free covenants).[62] Collection at the source applies at the present time only to (1) payments of fixed and determinable annual or periodical income to non-resident aliens in which case the tax is to be withheld at the rate of 8% (and if the Commissioner so rules the non-resident alien may claim exemption from withholding to the extent of his personal exemption); (2) payments of the same kind of income to non-resident foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, in which case the tax is to be withheld at the rate of 10%; and (3) the Commissioner may authorize deduction[63] at the source in the case of payments of any interest upon any securities the owners of which are not known to the withholding agent; (4) in the case of payments of interest on bonds and similar obligations of domestic corporations which contain a so-called "tax-free covenant," the tax to be withheld in all such cases to be limited to 2%, whether the owner be a citizen or resident or a non-resident alien or a foreign corporation or a domestic or foreign partnership. The only bondholders to which

[61] Id. § 224.

[62] Revenue Act of 1916, § 9 (c) as amended by Revenue Act of 1917.

[63] The law is not clear whether the Commissioner may authorize deduction at the rate of 8% or 10% in the case of bonds not having "tax-free covenants" and it seems to be within his discretion.

the last mentioned provision does not apply are domestic and resident corporations. The Commissioner may authorize the tax of 2% to be withheld on interest on "tax-free covenant" bonds where the owner is not known.[64] It is to be noted that the only case in which withholding against citizens or residents of this country takes place is (4) above. In such cases the law is made to operate in order that the debtor corporation issuing such "tax-free covenant" bonds may be compelled to assume a part of the tax of the bondholder, since withholding does not actually take place.[65]

Information at the Source. For the purpose of checking up the returns of taxpayers the law provides for a system of information at the source, whereby every corporation may be required to report to the Commissioner the names and addresses of its stockholders and the amount of dividends paid to each;[66] brokers may also be required, when called upon, to report the names and addresses of customers and furnish information as to the profits and losses of each;[67] and all persons, corporations or partnerships may be required to report the names and addresses of any persons to whom they pay fixed or determinable gains, profits or income of $1,000 or more in any taxable year. In the case of payments of interest to the bondholders of corporations the names and addresses of such bondholders are required to be reported regardless of the amount paid during the year, as is also the rule in the case of the collection of foreign items of interest and dividends.[68]

Payment of the Tax. The income tax is due and payable in four installments, each consisting of one-fourth of the total tax. The first installment is payable at the time when the return is due to be filed, unless an extension of time for filing the return is granted, in which case the first installment is due at the expiration of such extended period with interest at the rate of one half of one per cent. per month from the date on which the return was originally due to be filed. The return is required to be filed on the 15th day of March (or the 15th day of the third month fol-

64 Revenue Act of 1918, § 221 and § 237.

65 For a further discussion of this subject see Chapter 40.

66 Revenue Act of 1918, § 254.

67 Id. § 255.

68 Id. § 256.

lowing the close of the fiscal year), and the second, third and fourth installments are due on the 15th day of the sixth, ninth and twelfth months respectively after the close of the taxable year.[69] In the case of a taxpayer filing a return for the calendar year the first installment will de due on March 15, the second on June 15, the third on September 15 and the last on December 15. In the event of default in the payment of any installment the whole amount of tax still unpaid becomes due and payable upon notice and demand by the collector. The above provisions do not apply to taxes collected at the source. The tax may be paid in a single payment instead of in installments. It is then due or payable, when the return is filed, either at the date set by law or to which time to file the return has been extended.[70] No discount is allowed where such an advance payment is made. Receipts are no longer given for taxes paid, except upon the request of the taxpayer.[71]

Abatement and Refund. The collection of the income tax cannot be restrained by injunction, but the Commissioner is authorized to remit and pay back to the taxpayer any taxes which have been erroneously or illegally collected. The importance of collecting revenue is so great that the law permits no taxpayer to interpose a hindrance to the orderly assessment of the tax. He must allow the tax to be assessed and may thereafter claim abatement or refund.[72]

69 Id. § 250.
70 Id. § 250 (a).
71 Id. § 251.
72 See Chapter 38 for procedure as to abatement and refund.

CHAPTER 2

THE INCOME TAX RATES

As indicated in the foregoing chapter, the income tax is imposed generally at two rates (called the normal tax) on a part of the net income, and at a series of progressive rates (called the surtax) [1] on all the net income over $5,000. In the case of corporations no surtax is imposed, the income tax rate being uniform on all amounts of net income.

Normal Tax. Under the Revenue Act of 1918 a normal tax of 4% [2] is imposed upon the first $4,000 of taxable net income of citizens and residents for the calendar year 1919, and a normal tax of 8% [3] upon the remainder of such taxable net income.[4] In the case of non-resident alien individuals the rate is 8% [5] on the taxable net income.[6] In assessing the normal tax of citizens or residents the following items are deducted from net income to determine taxable net income: (a) the amount received as dividends from a corporation which is taxable for income tax purposes on its net income and from a personal service corporation out of earnings or profits subject to income tax; (b) the amount received as interest upon obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance

[1] In 1917 the income tax was assessed and collected under two laws (the Revenue Act of 1916 and the Revenue Act of 1917); but it is now assessed and collected under one law—The Revenue Act of 1918.

[2] This rate was 6% for the calendar year 1918.

[3] This rate was 12% for the calendar year 1918.

[4] Revenue Act of 1918, § 210 (b); Reg. 45, Art. 2. The subject of income is treated fully in Chapter 14 et seq.

[5] This rate was 12% for the calendar year 1918.

[6] In the case of non-resident alien individuals only income from sources within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States, is taxable (Revenue Act of 1918, § 213 (c)). But as to dividends, see p. 45.

Corporation, which is included in gross income; (c) the personal exemption.[7] In assessing the normal tax of non-resident alien individuals, the above items are deducted only on the condition that the non-resident alien files a return of his total income received from all sources, corporate or otherwise, in the United States, including therein all information which the Commissioner may deem necessary for the calculation of his credits and deductions;[8] and in the case of non-resident alien individuals who are citizens or subjects of a foreign country imposing an income tax, the personal exemption is allowed only if such country allows a similar credit to citizens of the United States not residing in such country.[9] On all the net income in excess of the above items and the personal exemption, the normal rates apply.[10]

COMPARATIVE STATEMENT OF NORMAL TAX RATES. The rates of normal tax under the various laws since March 1, 1913, are as follows:

1913—1%; 1916—2%; 1917—2%; 1918—6% and 12% for the year 1918 and 4% and 8% for subsequent years. The corporation tax for each of the years up to 1917 was the same as the normal tax. In 1917 the normal tax rates imposed by the 1916 and 1917 Laws were applied to incomes of citizens and residents, but only the 1916 rate to non-resident aliens, while the corporation tax was 6%.

Surtax. In addition to the normal tax a surtax is imposed at various and graduated rates under the present law. For the purpose of assessing the surtax the items deductible from net income for normal tax purposes and the personal exemption are not deducted.[11]

LIMITATION IN CASE OF SALES OF MINES, OIL OR GAS WELLS. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the surtax attributable to such sale

7 Revenue Act of 1918, §§ 210 and 216; Reg. 45, Art. 2.

8 Revenue Act of 1918, § 217.

9 Revenue Act of 1918, § 216 (e).

10 Revenue Act of 1918, § 211 (a).

11 Revenue Act of 1918, § 211 (a); Reg. 45, Art. 11. The surtax was called "the additional tax" in the 1916 Law and the 1917 Law.

cannot exceed 20% of the selling price.[12] Exploration work alone without discovery is not sufficient to bring a case within this provision. Shares of stock in a corporation owning mines, oil or gas wells do not constitute an interest in such property. To determine the application of this provision to a particular case, the taxpayer should first compute the surtax in the ordinary way upon his net income, including his net income from any such sale. The proportion of the surtax indicated by the ratio which the taxpayer's net income from the sale of the property, bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds 20 per cent of the selling price of the property such portion of the surtax shall be reduced to that amount.[13]

COMPARATIVE STATEMENT OF SURTAX RATES. The rates of surtax under the various laws since March 1, 1913, are as follows:

On the amount by which the total net income

Exceeds	But does not exceed	1918 Law	1917 Law	1916 Law	1913 Law
$ 5,000	$ 6,000	1%	1%	None	None
6,000	7,500	2%	1%	None	None
7,500	8,000	2%	2%	None	None
8,000	10,000	3%	2%	None	None
10,000	12,000	4%	3%	None	None
12,000	12,500	5%	3%	None	None
12,500	14,000	5%	4%	None	None
14,000	15,000	6%	4%	None	None
15,000	16,000	6%	5%	None	None
16,000	18,000	7%	5%	None	None
18,000	20,000	8%	5%	None	None
20,000	22,000	9%	7%	1%	1%

12 Revenue Act of 1918, § 211 (b).

13 Reg. 45, Art. 13. It should be noted that this construction of the statute is reached from the Government's viewpoint. The courts would perhaps under some circumstances hold that shares of stock in a corporation owning the property constitute an interest in the property within the meaning of the statute. It seems also that the method here presented for calculating the surtax applicable to such sale is open to question. The portion of the tax attributable to such sale is clearly the difference between the amount of surtax computed on the entire net income and the amount computed on the net income less the profit on the sale—and not the proportion indicated in the text.

Exceeds	But does not exceed	1918 Law	1917 Law	1916 Law	1913 Law
$22,000	$24,000	10%	7%	1%	1%
24,000	26,000	11%	7%	1%	1%
26,000	28,000	12%	7%	1%	1%
28,000	30,000	13%	7%	1%	1%
30,000	32,000	14%	7%	1%	1%
32,000	34,000	15%	7%	1%	1%
34,000	36,000	16%	7%	1%	1%
36,000	38,000	17%	7%	1%	1%
38,000	40,000	18%	7%	1%	1%
40,000	42,000	19%	10%	2%	1%
42,000	44,000	20%	10%	2%	1%
44,000	46,000	21%	10%	2%	1%
46,000	48,000	22%	10%	2%	1%
48,000	50,000	23%	10%	2%	1%
50,000	52,000	24%	10%	2%	2%
52,000	54,000	25%	10%	2%	2%
54,000	56,000	26%	10%	2%	2%
56,000	58,000	27%	10%	2%	2%
58,000	60,000	28%	10%	2%	2%
60,000	62,000	29%	14%	3%	2%
62,000	64,000	30%	14%	3%	2%
64,000	66,000	31%	14%	3%	2%
66,000	68,000	32%	14%	3%	2%
68,000	70,000	33%	14%	3%	2%
70,000	72,000	34%	14%	3%	2%
72,000	74,000	35%	14%	3%	2%
74,000	75,000	36%	14%	3%	2%
75,000	76,000	36%	14%	3%	3%
76,000	78,000	37%	14%	3%	3%
78,000	80,000	38%	14%	3%	3%
80,000	82,000	39%	18%	4%	3%
82,000	84,000	40%	18%	4%	3%
84,000	86,000	41%	18%	4%	3%
86,000	88,000	42%	18%	4%	3%
88,000	90,000	43%	18%	4%	3%
90,000	92,000	44%	18%	4%	3%
92,000	94,000	45%	18%	4%	3%
94,000	96,000	46%	18%	4%	3%

Exceeds	But does not exceed	1918 Law	1917 Law	1916 Law	1913 Law
$ 96,000	$ 98,000	47%	18%	4%	3%
98,000	100,000	48%	18%	4%	3%
100,000	150,000	52%	22%	5%	4%
150,000	200,000	56%	25%	6%	4%
200,000	250,000	60%	30%	7%	4%
250,000	300,000	60%	34%	8%	5%
300,000	500,000	63%	37%	9%	5%
500,000	750,000	64%	40%	10%	6%
750,000	1,000,000	64%	45%	10%	6%
1,000,000	1,500,000	65%	50%	11%	6%
1,500,000	2,000,000	65%	50%	12%	6%
2,000,000	....	65%	50%	13%	6%

The 1913 rates applied in 1913, 1914, and 1915; the 1916 rates in 1916; the 1916 and 1917 rates were both imposed in 1917, and the 1918 rates apply to 1918 and subsequent years.

SURTAX TABLES. The following table shows the surtax under the 1918 Law on net incomes of the specified amounts. In each instance the first figure of net income in the net income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the net income column, and the sum in the next column is the tax on the entire difference between the first figure and the second figure in the net income column. The final column gives the total surtax on a net income equal to the second figure in the net income column.

Net income	Per cent	Surtax	Total surtax
$ 5,000 to $ 6,000...	1	$ 10	$ 10
6,000 to 8,000...	2	40	50
8,000 to 10,000...	3	60	110
10,000 to 12,000...	4	80	190
12,000 to 14,000...	5	100	290
14,000 to 16,000...	6	120	410
16,000 to 18,000...	7	140	550
18,000 to 20,000...	8	160	710
20,000 to 22,000...	9	180	890
22,000 to 24,000...	10	200	1,090
24,000 to 26,000...	11	220	1,310

Net income		Per cent	Surtax	Total surtax
$ 26,000 to	$ 28,000...	12	$ 240	$ 1,550
28,000 to	30,000...	13	260	1,810
30,000 to	32,000...	14	280	2,090
32,000 to	34,000...	15	300	2,390
34,000 to	36,000...	16	320	2,710
36,000 to	38,000...	17	340	3,050
38,000 to	40,000...	18	360	3,410
40,000 to	42,000...	19	380	3,790
42,000 to	44,000...	20	400	4,190
44,000 to	46,000...	21	420	4,610
46,000 to	48,000...	22	440	5,050
48,000 to	50,000...	23	460	5,510
50,000 to	52,000...	24	480	5,990
52,000 to	54,000...	25	500	6,490
54,000 to	56,000...	26	520	7,010
56,000 to	58,000...	27	540	7,550
58,000 to	60,000...	28	560	8,110
60,000 to	62,000...	29	580	8,690
62,000 to	64,000...	30	600	9,290
64,000 to	66,000...	31	620	9,910
66,000 to	68,000...	32	640	10,550
68,000 to	70,000...	33	660	11,210
70,000 to	72,000...	34	680	11,890
72,000 to	74,000...	35	700	12,590
74,000 to	76,000...	36	720	13,310
76,000 to	78,000...	37	740	14,050
78,000 to	80,000...	38	760	14,810
80,000 to	82,000...	39	780	15,590
82,000 to	84,000...	40	800	16,390
84,000 to	86,000...	41	820	17,210
86,000 to	88,000...	42	840	18,050
88,000 to	90,000...	43	860	18,910
90,000 to	92,000...	44	880	19,790
92,000 to	94,000...	45	900	20,690
94,000 to	96,000...	46	920	21,610
96,000 to	98,000...	4[illegible]	940	22,550
98,000 to	100,000...	48	960	23,510
100,000 to	150,000...	52	26,000	49,510
150,000 to	200,000...	56	28,000	77,510

Net income	Per cent	Surtax	Total surtax
$ 200,000 to $ 300,000...	60	$ 60,000	$137,510
300,000 to 500,000...	63	126,000	263,510
500,000 to 1,000,000...	64	320,000	583,510
1,000,000 up	65		

The surtax for any amount of net income not shown in the above table is computed by adding to the total surtax for the largest amount shown which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. For example, if the amount of net income is $63,128, the surtax is the sum of $8,690 (the surtax upon $62,000 as shown by the table) plus 30 per cent of $1,128, or $338.40, making a total surtax of $9,028.40.[14]

COMPUTING THE TAX—ILLUSTRATION. The tax on a married person with a net income of $15,000 for the year 1919, assuming that none of such income consists of (a) dividends from a corporation taxable for income tax purposes on its net income, or a personal service corporation out of earnings or profits subject to income tax, or (b) interest upon obligations of the United States or bonds issued by the War Finance Corporation, is computed as follows:

Normal Tax	Rate	Amount of Tax
$15,000 minus $2,000 (personal exemption) equals $13,000		
First $4,000 at..........	4%	$160
Remaining 9,000 at..........	8%	720
Surtax		
On first $5,000...............	0%	0
On next 1,000............... ($5,000 to $6,000)	1%	10
On next 2,000............... ($6,000 to $8,000)	2%	40
On next 2,000............... ($8,000 to $10,000)	3%	60
On next 2,000............... ($10,000 to $12,000)	4%	80
On next 2,000............... ($12,000 to $14,000)	5%	100
On next 1,000............... ($14,000 to $15,000)	6%	60
		Total, $1,230

[14] Reg. 45, Art. 12.

The tax on an unmarried person would be increased by 8% on \$1,000 or \$80, since the personal exemption is \$1,000 less, and the balance of taxable net income over \$4,000 would be increased accordingly. In case a married person or the head of a family is entitled to further exemption because of persons dependent upon him, the normal tax will be reduced at the rate of \$16 for each such dependent, that is, 8% on \$200.[15]

Husband and Wife. Where a husband and wife make returns of their joint incomes, neither the normal tax nor surtax is to be computed on the joint income of both, but on the separate income of each although the incomes of both may be reported in the same return.[16]

Surtax on Stockholders in Respect of Undistributed Profits of Corporations. The surtax is ordinarily assessed only upon income actually received by the taxpayer. But if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate, instead of being divided or distributed, the corporation is not subject to income tax, and the stockholders are taxable as stockholders of a personal service corporation, except that the excess-profits tax paid by the corporation will be deducted from its net income before the computation of the proportionate share of each stockholder or member.[17] This provision applies only where the accumulation is permitted for the purpose of avoiding the surtax. Ordinarily, the stockholder of a corporation has no need to concern himself with or to make any inquiry as to the undistributed income of the corporation.[18] The fact that a corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business is prima facie evidence of a purpose

15 Revenue Act of 1918, § 216 (d).

16 Revenue Act of 1918, § 216 (c); Reg. 45, Art. 2; T. D. 2090; T. D. 2137.

17 Revenue Act of 1918, § 220. This provision is broader than the provision contained in the 1916 Law, which authorized the Commissioner to assess a tax on the shareholders with respect to the undistributed profits only in cases where such profits were allowed to accumulate with fraudulent intent to avoid the surtax. Compare the section with section 3 of the Revenue Act of 1916. The taxation of personal service corporations is discussed in Chapter 9.

18 See T. D. 2135.

to escape the surtax. The collectors, however, have no authority to decide when gains and profits are accumulated beyond the reasonable needs of the business so as to be taxable as indicated above. The Commissioner must first certify that in his opinion the accumulation is unreasonable.[19] In any case the Commissioner or a collector may require a corporation to furnish a statement of its gains and profits and of the names, addresses, and shareholdings of the stockholders, and if upon the basis of such statement or other evidence the Commissioner certifies that in his opinion its accumulation of profits is unreasonable for the purposes of the business, the corporation and its stockholders must make their returns accordingly.[20] When the Commissioner has so certified, the stockholders are notified and called upon to add the amount of their respective shares in the undistributed gains and profits of the corporation for the year to their income from other sources and to pay the surtax accordingly.

PURPOSE TO ESCAPE SURTAX. The application of the rule stated in the foregoing paragraph depends upon the two elements of (a) purpose to escape the surtax and (b) unreasonable accumulation of gains and profits. Prima facie evidence of (a) exists where a corporation has practically no business except holding stocks, securities or other property and collecting the income therefrom, or where a corporation other than a mere holding company permits its gains and profits to accumulate beyond the reasonable needs of the business. The business of a corporation is not limited to that which it has previously carried on, but in general includes any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the

19 Revenue Act of 1918, § 220.
20 Reg. 45, Art. 351.

business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business.[21]

Unreasonable Accumulation of Profits. An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business.[22]

[21] Reg. 45, Art. 352.
[22] Reg. 45, Art. 353.

CHAPTER 3

INDIVIDUALS TO WHOM THE LAW IS APPLICABLE

The theory upon which the income tax is imposed seems to be two-fold. The law imposes the tax upon the net income of all persons within its jurisdiction, regardless of the source of such income, and upon all income arising from sources within the United States, regardless of whether or not the United States has jurisdiction of the recipient. The tax has been defined as a tax on the person, measured by his ability to pay, that is, his net income,[1] and as a tax on the income itself.[2] As a matter of fact, it is both. The Government claims personal jurisdiction over all

[1] In Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 564, the court said: "In our opinion the tax is against the citizens and residents of the United States personally. They are chargeable in respect to income received by them." In State ex rel. Moon Co. against Wisconsin Tax Commission (Wis.) 163 N. W. 673, the Court said: "Much confusion of thought arises from regarding the income tax as a tax that is levied upon or attaches to property as such, irrespective of the person sought to be taxed. It is the recipient of the income that is taxed, not his property; and the vital question in each case is, Has the person sought to be taxed received an income during the tax year? If so, such income, unless specifically exempted, is subject to a tax though the property out of which it is paid may have been exempt from an income tax in the hands of the payor. It is the relation that exists between the person sought to be taxed and specific property claimed as income to him that determines whether there shall be a tax. If the person sought to be taxed is the recipient during the tax year of such specific property as income in its ordinary significance, then the person is taxed. But the tax is upon the right or ability to produce, create, receive, and enjoy, and not upon specific property. Hence the amount of the tax is measured by the amount of the income, irrespective of the amount of specific property or ability necessary to produce or create it. In the ordinary acceptation of the term this may be said to be a tax upon income as the statute denominates it. But the tax does not seek to reach property, or an interest in property as such. It is a burden laid upon the recipient of an income."

[2] In a case decided by the Supreme Judicial Court of Massachusetts, Suter v. Jordan-Marsh Company, 113 N. E. 580, it was held that the tax was levied upon the rent paid by the defendant to the plaintiff. See also Catawissa R. Co. v. Phila. & Reading Co., 255 Pa. St. 269, 99 Atl. 807.

of its citizens wherever they reside and over all aliens who reside within the borders of the United States. Hence, as to citizens and resident aliens, the tax is imposed on income from all sources whether arising in this country or in a foreign country. No jurisdiction can be claimed over the persons of nonresident aliens, but insofar as their income is received from sources within this country, it is taxed on the theory that the Government has jurisdiction over the income, grants protection to the creation of such income, and is, therefore, entitled to a share thereof to defray the expenses of government.[3] The fact that a person is taxable in foreign countries on all or part of his income does not relieve him from tax liability on the same income in this country,[4] although he is entitled under the Revenue Act of 1918 to a credit in certain cases against his tax liability in this country by reason of the payment of taxes to foreign countries.[5]

Persons Exempt from the Tax. Individuals may enjoy exemption from the income tax by reason of the *amount* or *character* of their income.

EXEMPTION BASED ON AMOUNT OF INCOME. Citizens and residents receiving less than $1,000 of net income during the year, if single, or less than $2,000, if the head of a family or a married person living with husband or wife, are exempt from the tax. Such persons are not required to file returns of annual income, but on demand of the Commissioner they may be required to file a statement sufficient to satisfy him that they are not liable.[6] Non-resident aliens are allowed the same personal exemptions of $1,000 and $2,000 on income received from sources within the United States if they file the required returns,[7] and provided the country of which they are citizens or subjects, if it imposes an income tax, allows a similar credit to citizens of the United States not residing in such foreign country.[8] Citizens of possessions of the United States (but not otherwise citizens of the

[3] Reg. 45, Art. 3. See Union Ref. Transit Co. v. Kentucky, 199 U. S. 194.

[4] T. D. 2152.

[5] Revenue Act of 1918, §§ 222, 238. This credit against a person's tax should not be confused with the deduction of taxes in order to determine net income.

[6] Revenue Act of 1918, §§ 223, 1305.

[7] Reg. 45, Art. 311-316.

[8] Revenue Act of 1918, §§ 216 (e), 217.

United States), who are not residents of the United States, are subject to taxation in the United States under the Revenue Act of 1918 only as to income derived from sources within this country.[9]

EXEMPTION BASED ON CHARACTER OF INCOME. Individuals may also enjoy an exemption from the tax because of the character of their income, since the law expressly provides that certain kinds of income shall not be included in gross income and shall be exempt from the tax. Among the items of income so exempt [10] are: (a) the proceeds of life insurance policies paid upon the death of the insured, to individual beneficiaries, or to the estate of the insured, (b) the amount received by the insured as return of premiums paid by him under life insurance, endowment or annuity contracts, (c) property acquired by gift, bequest, devise or descent (but the income from such property is taxable), (d) amounts received through accident or health insurance or under Workmen's Compensation Acts as compensation for personal injuries or sickness and the amount of any damages received whether by suit or agreement on account of such injuries or sickness, (e) so much of the amount received during the war with Germany by a person in the military or naval forces, as salary or compensation in any form from the United States, for active services in such forces, as does not exceed $3,500.[11] Income derived from the operation of a public utility is also exempt to a certain extent and under certain conditions, as is indicated more fully in another chapter.[12] Interest upon (1) the obligations of a State, Territory or any political subdivision thereof, the District of Columbia, or any possession of the United States, (2) securities issued under the provisions of the Federal Farm Loan Act, (3) the obligations of the United States, issued prior to September 1,

9 Revenue Act of 1918, § 260.

10 Revenue Act of 1918, § 213.

11 The term "active services" is used in the sense of services in all military and naval branches at home or abroad, as contradistinguished from the retired or reserve list and is not confined merely to services in the field or the theatre of war. The term "military or naval forces" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female. The term also includes Army contract surgeons, but does not include members of draft boards. (Reg. 45, Art. 86.) This subject is more fully discussed in Chapter 15.

12 See Chapter 14.

1917, is exempt. But every person owning any such obligations, securities or bonds, is required to submit a statement in his return, showing the number and amount thereof, and the interest received therefrom. The interest upon obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation is exempt only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented, and may be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and excess-profits taxes.[13] The 1916 Law expressly exempted the compensation of the present President of the United States, during the term for which he has been elected, and the compensation of the Judges of the Supreme Court and inferior courts of the United States, in office at the time the Act was passed, but the Revenue Act of 1918 expressly taxes the compensation received as such of the President, the Judges of the Supreme Court and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia.[14] The Revenue Act of 1918 does not expressly exempt "the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government,"[15] as did the 1916 Law. It seems to have been the intent of Congress in the present statute to tax such salaries and to leave the constitutional question involved in levying the tax to the courts,[16] but the Treasury Department has ruled that compensation paid to its officers and employees by a state or any political subdivision thereof, will not be taxed.[17] Exempt income is ordinarily omitted from the returns of individuals and corporations,[18] but income exempt only from normal tax and not

13 Revenue Act of 1918, § 213 (b) 4, § 233.

14 Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 15.

15 Revenue Act of 1916, § 4.

16 Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 15.

17 Reg. 45, Art. 85. This subject is more fully discussed in Chapter 15.

18 Reg. 45, Art. 71. Exempt interest, however, is included, as above indicated. The exclusion of such income should not be confused with the reduction of taxable income by the application of allowable deductions. Under the

from surtax, or from the income tax but not from the excess-profits tax, must be included in the return.

Citizens of the United States. Citizens of the United States are taxable upon their net income from *all* sources, whether they reside in this country or not.[19] It makes no difference that they may own no assets within the United States and may receive no income from sources within the United States.[20] They are taxable for the purpose of the *surtax* upon their entire net income received in each year from all sources and for the purpose of the normal tax upon net income less statutory credits.[21] Income wholly exempt is not included in gross income, the foundation for the computation of net income.[22] On dividends of corporations taxable upon their net income and dividends of personal service corporations, out of earnings or profits upon which income tax has been imposed, they are liable only for the surtax; and so also with respect to interest on bonds of the United States issued after September 1, 1917, and bonds of the War Finance Corporation.[23] The regulations and rulings respecting taxable and nontaxable income are, as a rule, applicable both to individuals and corporations, and are discussed in detail in the later chapters on income.[24]

WHO IS A CITIZEN. Every person born in the United States subject to its jurisdiction, or naturalized in the United States, is a citizen. An individual born in the United States of citizen or resident alien parents, who has long since moved to a foreign country and established a domicile there, but who never has been naturalized therein or taken an oath of allegiance thereto is still a citizen of the United States.[25] Married women are considered

1916 law corporations were at first required to report exempt income in a supplementary statement, but this requirement was omitted in later forms.

19 In U. S. v. Goelet, 232 U. S. 293, the court held that a United States citizen permanently residing or domiciled aboard was not liable to the tax on foreign-built yachts imposed by the tariff Act of August 5, 1909. The court said that "the taxing power, when exerted, is not usually applied to those even albeit they are citizens, who have a permanent domicile or residence outside of the country levying the tax."

20 Reg. 45, Art. 3.

21 Reg. 45, Arts. 3 and 21.

22 Revenue Act of 1918, § 212; Reg. 45, Art. 21.

23 Revenue Act of 1918, § 216.

24 See Chapters 14-20.

25 Reg. 45, Art. 4.

to have the same citizenship as their husbands. An American woman who marries a foreigner consequently loses her status as an American citizen and is thereafter treated as an alien.[26] Determination by the State Department of the status of an individual is not conclusive upon the Treasury Department in fixing citizenship for income tax purposes.[27]

CITIZENS RESIDING IN THE UNITED STATES. Citizens residing in the United States report and pay the tax in the district in which they legally reside or have their principal place of business, regardless of where their income may arise.[28]

CITIZENS RESIDING ABROAD. If a citizen residing abroad has no office or place of business in this country, he files his return and pays his tax to the Collector at Baltimore, Maryland. He is, of course, required to report his income from all sources, whether within or without the United States. Although the question as to the liability of a nonresident citizen is determined by the Treasury Department, not by the State Department, still, in the case of a *naturalized* citizen against whom the presumption of expatriation has arisen, the fact that he has paid the income tax will receive due consideration by the State Department in connection with other evidence submitted to overcome such presumption in connection with applications for passports or for registration in a consulate or for actual protection in a foreign country. The payment of the income tax will also be duly considered by the State Department in passing upon rights to the continued protection of this Government in cases of *native* American citizens who have resided abroad for a period sufficiently prolonged to raise the natural presumption that they have abandoned citizenship in this country.[29]

Aliens Residing in the United States. All residents of this country, even though they may be aliens, are classified with citizens of the United States for the purpose of income tax, and are taxable upon their entire net income from all sources.[30]

[26] T. D. 2092.

[27] T. D. 2135.

[28] Revenue Act of 1918, § 227 (b); Reg. 45, Art. 448.

[29] Letter from Secretary of State to American Diplomatic and Consular Officers, dated March 18, 1914; I. T. S. 1918, ¶ 5; Revenue Act of 1918, § 227 (b).

[30] Reg. 45, Art. 3.

Who Are Resident Aliens. The question whether or not an alien resides in this country is sometimes difficult to determine. The Treasury Department holds that the term "nonresident alien individual" means an individual (a) whose residence[31] is not within the United States, and (b) who is not a citizen of the United States. Any alien living in the United States who is not a mere transient is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to his stay. If he lives in the United States and has no definite intention as to his stay, he is a resident. The best evidence of such intentions is afforded by the conduct, acts, and declarations of the alien. The typical transient is one who stops for a short time in the course of a journey through the United States, sometimes performing labor, sometimes not, or one who enters the United States intending only to stop long enough to carry out some purpose, object, or plan not involving an extended stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. An alien's statements as to his intention with regard to residence are not conclusive, but when unequivocal will determine the question of his intention, unless his conduct, acts, or other surrounding circumstances contradict the statements. It sometimes occurs that an alien who genuinely intends his stay to be transient may put off his departure from time to time by reason of changed conditions, remaining a transient though living in the United States for a considerable time. The fact that an alien's family is abroad does not necessarily indicate that he is a transient rather than a resident. An alien who enters this country intending to make his home in a foreign country as soon as he has accumulated a sum of money sufficient to provide for his journey abroad is to be considered a transient, provided his expectation in this regard may reasonably, considering the rate of his saving, be fulfilled within a comparatively short time. It will be presumed that an alien who has established a residence

31 The Treasury Department has adopted the following definition of the word "residence" as used in the income tax laws: "That place where a man has his true, fixed and permanent home and principal establishment, and to which, whenever he is absent, he has the intention of returning; and indicates permanency of occupation as distinct from lodging or boarding, or temporary occupation." (T. D. 2242.)

in the United States, as outlined above, continues to be a resident until he or his family evidence an intention to change their residence to another country by starting to remove. Thus, alien residents who, following the armistice agreement of November 11, 1918, take steps toward returning to their native countries, as by applying for passports, may for the purpose of withholding, be regarded as residents for that portion of the taxable year which elapsed up to the time such step was taken. But the status of the alien on the last day of his taxable year or period determines his liability to tax for such year or period as a resident or non-resident.[32] Aliens coming into the United States with the intention of becoming residents and other resident aliens can establish the fact of their residence and acquire the privileges of resident aliens under the statute, by filing a certificate with the withholding agents charged with the duty of withholding the tax on income paid to non-resident aliens.[33] The distinction between resident and non-resident aliens is also discussed elsewhere in this book.[34]

Non-Resident Aliens.[35] Non-resident aliens are those individuals who are neither citizens nor residents of this country.[36] As stated above, they are taxable only on that part of their income which is from sources within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.[37]

[32] Reg. 45, Arts. 312, 313, and 314. This rule differs from the English rule which provides that a person within the United Kingdom, for some temporary purpose only for less than six months during the year, is not taxable as a resident, but after a residence of six months he becomes chargeable with the duties for the year commencing on April 6th preceding.

[33] Reg. 45, Art. 362; T. D. 2242. This certificate is known officially as Form No. 1078 (Revised).

[34] See Chapter 4.

[35] The term "non-resident alien" is defined more fully in Chapter 4.

[36] Reg. 45, Art. 312. A citizen of a possession of the United States, who is not otherwise a citizen or a resident of the United States, including only the States, the territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a non-resident alien individual (Reg. 45, Art. 1121; Revenue Act of 1918, § 260).

[37] Revenue Act of 1918, § 213 (c).

If a non-resident alien conducts business through an agent in this country, the agent will be subject to the duty of filing a return for his non-resident principal and of paying both the normal tax and the surtax on his behalf.[38]

Taxation of Individuals between United States and Porto Rico and Philippine Islands. A citizen of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, are taxed in both places, but the income tax in the United States is credited with the amount of any income, war profits and excess profits taxes paid in Porto Rico. A resident of the United States, who is not a citizen of Porto Rico, is taxable in Porto Rico as a nonresident alien individual on any income derived from sources within Porto Rico, but the income tax in the United States is credited with the tax paid in Porto Rico. A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a non-resident alien individual on any income derived from sources within the United States, and receives no credit. The same principles apply in the case of the Philippine Islands.[39]

Husband and Wife. In so far as possible the family is treated as a unit for purposes of the income tax, and the husband and wife may make joint returns.[40] Unless the wife files a separate return or joins with her husband in a return which sets forth her income separately, her husband should include in his return the income accruing to the wife from services rendered by her or the sale of products of her labor.[41] The personal exemption is in such cases deducted from the joint income, but both the normal tax and the surtax is in all cases imposed upon the separate incomes.[42]

Minors. Under the 1916 and 1917 Laws, minors[43] were not required to make returns for themselves, their returns being required to be made by their guardians.[44] This rule is now

[38] Revenue Act of 1918, § 223; Reg. 45, Art. 404.

[39] Reg. 45, Art. 1132.

[40] Revenue Act of 1918, § 223. See Chapter 34.

[41] Reg. 45, Art. 401.

[42] Reg. 45, Art. 2; T. D. 2090.

[43] A minor is a person under 21 years of age or under the statutory age of majority where he lives. (Reg. 45, Art. 403.)

[44] Reg. 33, Art. 17; Letter from Treasury Department dated April 11, 1918; I. T. S. 1918, ¶ 3295.

changed, and minors are required to make returns unless their income is included in the return of the parent or reported by a fiduciary.[45]

Incompetents. Incompetents or insane persons are unable to make their own returns, and their returns must be made by the guardian or other person charged with the care of the person or property of such incompetent or insane person.[46]

Agents. The return of a taxpayer may be made by an agent when by reason of illness, absence, or nonresidence the person liable for the return is unable to make it, the agent assuming the responsibility for making the return and incurring liability to the specific penalties provided for erroneous, false, or fraudulent returns.[47] Responsible representatives of non-resident aliens having charge of the property of non-resident aliens may be charged with the duty of making a return and paying the tax normal and additional, on the income passing through their hands.[48]

Fiduciaries. Guardians, trustees, executors, administrators, receivers, conservators or any persons acting in a fiduciary capacity are charged with special duties under the law. These duties are fully discussed in another chapter.[49]

Persons Dying During the Year. When a person dies during any calendar year, it is the duty of the executor or administrator or person taking charge of his property to make a return for the deceased from the beginning of the year to the date of death.[50] In case the decedent dies after the close of the calendar year, but before March 15th of the following year, and has not made a return for the preceding calendar year, a return should be made for the full year preceding and in addition a return from January 1 of the current year to the date of death. If during the period in which the decedent lived he was not in receipt of

[45] Revenue Act of 1918, § 223; Reg. 45, Art. 403. This change was accomplished by the omission of the words "of lawful age" from the section requiring returns of individuals. Compare Revenue Act of 1916, § 8 (b) with Revenue Act of 1918, § 223. This subject is more fully discussed in Chapter 34.

[46] Revenue Act of 1918, § 223; Reg. 45, Art. 422.

[47] Revenue Act of 1918, § 223.

[48] Revenue Act of 1918, § 223; Reg. 45, Art. 404. See Chapter 5.

[49] Revenue Act of 1918, § 225. See Chapter 6.

[50] Reg. 45, Art. 421. Mandell v. Pierce, 3 Cliff 134, 16 Fed. Cas. No. 9008.

$1,000 of net income, if unmarried, or $2,000 if married or the head of a family, no return need be filed,[51] unless he was a non-resident alien, in which case a return should be filed, whether he was married or single, regardless of amount.[52] The fact that a person may have died before the passage of the law does not relieve his estate from liability to tax, if he lived after the incidence of the tax.[53]

[51] Reg. 45, Art. 421.

[52] Reg. 33, Rev., Arts. 4 and 14; Reg. 45, Art. 403.

[53] Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654. Thus, a person dying after January 1, 1919, but before February 25, 1919, the date on which the 1918 Law went into effect, will be held to be taxable thereunder. The effect of making the act retroactive is to apply it to him exactly as if it had been enacted on January 1, 1918.

CHAPTER 4

NON-RESIDENT ALIENS

The law imposes a tax upon the net income received by non-resident alien individuals "from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States." The term "non-resident aliens," as used in several places in the 1916 Law, was not defined therein, but clearly referred to individuals only and not to partnerships, corporations, or associations. The Revenue Act of 1918, however, removes all doubt by using the expression "non-resident alien *individuals*."[1] The expression "non-resident aliens" is used in this chapter to mean only non-resident alien individuals.

Who Is a Non-Resident Alien. Ordinarily it is a simple matter to determine whether an individual is or is not a non-resident alien; he falls into this class if he is neither a citizen nor a resident. Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of United States) and who is not a resident of the United States is subject to income tax upon income derived from sources within the United States, and his tax is computed and paid in the same manner and subject to the same conditions as the tax of non-resident aliens who are citizens or subjects of foreign countries.[2] The term "non-resident alien," therefore, is used in this chapter to include any non-resident citizen of any possession of the United States. Dif-

1 Revenue Act of 1918, §§ 210 and 213 (c); Reg. 45, Art. 3.

2 Revenue Act of 1918, § 260. Income of citizens and residents of Porto Rico or the Philippines is taxed in those jurisdictions in accordance with the provisions of the Revenue Act of 1916, as amended, the legislatures of Porto Rico and the Philippines having power to amend, alter, modify or repeal that law in their respective jurisdictions (Revenue Act of 1918, § 261).

ficulty may arise in determining whether an individual is or is not a non-resident alien, where a non-resident citizen, naturalized or native, has resided abroad for a period sufficient to raise a presumption that he has abandoned his citizenship,[3] and again where an alien has resided in this country for a period so long as to raise a presumption of residence. In either of these cases the intent of the individual is important. The Treasury Department holds that the status of a non-resident native or naturalized citizen remains unchanged until some affirmative action is taken, or the right to citizenship is forfeited by some overt act.[4] When any naturalized citizen has left the United States and resided for two years in the foreign country from which he came, or for five years in any other foreign country, he is presumed to have lost his American citizenship; but this presumption does not apply to residence abroad while the United States is at war. An Italian, who has come to the United States and filed his declaration of intention to become a citizen, but who has not yet received his final citizenship papers, is an alien. A Swede, who, after having come to the United States and become naturalized here, returned to Sweden and resided there for two years prior to April 6, 1917, is presumed to be once more an alien.[5] On the other hand, an alien, coming to the United States with the intention of becoming a resident within the meaning and intent of the income tax statute, may indicate that fact and thereupon will be taxed as a resident, re-

[3] The Act of March 2, 1907, provides, briefly, that any American citizen becomes an alien by becoming naturalized in a foreign state or taking an oath of allegiance to any foreign state. A naturalized citizen residing for two years in the country from which he came or for five years in any other foreign country, is presumed to have renounced his American citizenship in the absence of satisfactory evidence to the contrary. A woman assumes the nationality of her husband, but may resume her original citizenship on becoming a widow; she assumes or retains her American citizenship as a widow if, living abroad, she registers with a United States consul, or without formal action if she resides here. Minor children of naturalized citizens are deemed to be citizens from the time they begin to reside permanently in this country. Children born outside of the United States of citizens, and continuing to reside abroad must at the age of 18 declare their intention as to citizenship. Determination of citizenship by the State Department under this Act is not conclusive upon the Treasury Department; other factors may also be considered, as indicated in the text.

[4] T. D. 2135.

[5] Reg. 45. Art. 4.

gardless of the length of time he has been here.[6] The tests as to the residence of aliens located within this country have been set forth in another chapter.[7]

RESIDENCE OF ALIEN SEAMEN. In order to determine whether an alien seaman is a resident within the meaning of the income tax law, it is necessary to decide whether the presumption of non-residence is overcome by facts showing that he has established a residence in the territorial United States, which consists of the States, the District of Columbia, and the Territories of Hawaii and Alaska, and excludes other places. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the territorial United States, although the nature of his calling requires him to be absent from the place where his residence is established for a long period. An alien seaman may acquire such a residence at a sailor's boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 (Revised), or taking out first citizenship papers, is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence, because the head tax is payable unless the alien who is entering the country is merely in transit through the country. An alien may remain a non-resident although he is not in transit through the country.[8]

Extent to Which Non-Resident Aliens Are Taxable. Non-resident aliens are subject to the normal tax and the surtax imposed by the Revenue Act of 1918, upon their net income received from all sources within the United States, including interest on bonds,

[6] Reg. 45, Art. 313; T. D. 2242. See Chapter 3 for status of resident aliens.

[7] See Chapter 3.

[8] Reg. 45, Art. 312a; T. D. 2869. As to when the wages of alien seamen are subject to tax, see Reg. 45, Art. 92a and page 47.

notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.[9] Non-resident aliens are not taxed at the lower rate of normal tax upon the first $4,000 of their taxable net income as are citizens or residents, but their entire taxable net income is subject to a normal tax of 8%.[10]

Income from Sources Within the United States. The words "sources within the United States" are not defined in the law

9 Revenue Act of 1918, §§ 210 and 213 (c); Reg. 45, Art. 3. This rate was 12% for the taxable year 1918. The 1913 Law, which was repealed by the 1916 Law, imposed a tax on the net income of non-resident aliens "from all property owned and from every business, trade, or profession carried on in the United States." This language was held, under two opinions of the Attorney General, not to include interest or dividends received by non-resident alien investors from domestic corporations, but on March 21, 1916, the Treasury Department reversed this holding and thereafter claimed the tax from non-resident aliens on the classes of income in question. (T. D. 2313.) In DeGanay v. Lederer, 239 Fed. 568, the District Court held a non-resident alien taxable on such income if the stock certificates and bonds were kept in this country, as then they acquired a situs here for purposes of the income tax. This decision has now been affirmed by the United States Supreme Court which takes the position that stock certificates, bonds, and mortgages are "property" within the meaning of the statute, having a situs within the United States in spite of the maxim *mobilia sequuntur personam*. The court said:—"In the case under consideration the stocks and bonds were those of corporations organized under the laws of the United States, and the bonds and mortgages were secured upon property in Pennsylvania. The certificates of stock, the bonds and mortgages were in the Pennsylvania Company's offices in Philadelphia. Not only is this so, but the stocks, bonds and mortgages were held under a power of attorney which gave authority to the agent to sell, assign, or transfer any of them, and to invest and reinvest the proceeds of such sales as it might deem best in the management of the business and affairs of the principal. It is difficult to conceive how property could be more completely localized in the United States. There can be no question of the power of Congress to tax the income from such securities. Thus situated and held, and with the authority given to the local agent over them, we think the income derived is clearly from property within the United States within the meaning of Congress as expressed in the statute under consideration." The language of the 1916 Law and the present law expressly included such income, regardless of where the securities might be kept.

10 Revenue Act of 1918, § 210 (a); Reg. 45, Art. 2.

and their interpretation raises many difficult questions. The term is very broad and was intended to include income of all kinds from sources over which this country has jurisdiction. No cases have arisen in the courts involving construction of the phrase. The most comprehensive ruling defining gross income from sources within the United States includes in the term, in addition to the items specified in the statute, rentals, and royalties from property, and income from business carried on in the United States, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States, and income from services rendered or labor performed within the United States.[11] The tax does not apply to charter money or freight payments received by a foreign owner in regard to a vessel operated between the United States and foreign ports, if the person receiving the income maintains no regular agency in the United States and is not doing business in the United States. Compensation received by non-resident alien munitions inspectors and purchasing agents, from foreign governments, is not subject to the tax.[12] The term "income" includes gains, profits and income derived from all salaries, wages or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or income derived from any sources whatever.[13] Non-resident aliens are not taxed on income specified in the law to be exempt.[14]

INCOME FROM BUSINESS BRANCHES. Where a non-resident alien establishes a branch of his business in this country, the net in-

11 Reg. 45, Art. 91. Until the latest revision of Regulations 45 income from isolated transactions or activities directly resulting in gain, carried on within the United States by a non-resident or his representative in person, was stated to be from sources within the United States, but the Treasury Department seems now to have abandoned this position.

12 Reg. 45, Art. 92.

13 Revenue Act of 1918, § 213 (a). Compare this section with § 2 (a) of the Revenue Act of 1916.

14 Revenue Act of 1918, § 213. Exempt income is generally exempt regardless of the status of the recipient. See Chapter 14 for a further discussion of this point and the exceptions to such general rule.

come of that branch is subject to tax, and this would seem to be true even though a portion of that income may be received by the branch from business done in foreign countries, but the precise point is as yet unsettled. If two or more branches are established here, the total net income from all is taken together for purposes of assessment. The income of all branches should be reported by the principal branch in its district, the other branches not being assessable in their respective districts.[15]

DIVIDENDS. Non-resident aliens are not subject to the normal tax on income received as dividends from a corporation taxable under the law upon its net income. They are also not subject to the normal tax on amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed. They must, however, in order to secure the credit of such dividends, file a return of their total net income received from all sources, corporate or otherwise, in the United States including the dividends in question.[16] If the total taxable income of all kinds from sources within the United States, together with such dividends and interest as are allowed to be credited for purposes of the normal tax, and together with any personal exemption which may be allowed, exceeds $5,000, the surtax must be paid at the prescribed rates.[17] The exemption of dividends from the normal tax applies not only to dividends received direct from a corporation, but also to dividends received through the medium of fiduciaries or partnerships.[18] Dividends of non-resident foreign corporations, that is, corporations not engaged in trade or business within the United States and not having any office or place of business in this country, are not taxable in the hands of a non-resident alien, even though such dividends may be payable in this country.[19] Dividends on stock of corpo-

15 Generally, the rules applying to foreign corporations as to income from business done in this country apply equally to non-resident alien individuals. See Chapter 12.

16 Revenue Act of 1918, §§ 216 and 217.

17 See Chapter 2.

18 See Chapter 19 for a further discussion of this subject.

19 Revenue Act of 1918, § 213 (c). See also T. D. 2012, T. D. 2030, T. D. 2313, T. D. 2325; Letter from Treasury Department dated April 5, 1916, I. T. S. 1919, ¶ 687. In two provisions of the 1916 Law (Revenue Act of 1916, §§ 1 (b) and 8 (b)) non-resident aliens were excepted from the require-

rations organized in the United States, but doing no business in the United States and owning no property therein, are held not to be taxable when paid to non-resident aliens.[20]

INTEREST. Non-resident aliens are taxable upon all interest on bonds, notes or other interest-bearing obligations of *residents* of this country, corporate or otherwise, but for the purpose of the normal tax they are entitled to a credit of any amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[21] In order to obtain such credit, they must file a return of their total income received from all sources, corporate or otherwise, in the United States.[22] Interest received from a non-resident, corporate or otherwise, is not taxable. Interest upon obligations of corporations organized in the United States, but doing no business and owning no property therein, is not taxable when paid to non-resident aliens.[23]

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. Interest received on and after March 3, 1919, on bonds, notes and certificates of indebtedness of the United States, and bonds of the War Finance Corporation, while beneficially owned by a non-resident alien individual, or a foreign corporation, partnership

ments of making reports on and paying the surtax on "such income (income derived from dividends on the capital stock or from the net earnings of any corporation) derived from sources without the United States." Although this language was not construed by the courts or by any regulation, it undoubtedly applied to dividends received from foreign corporations where the earnings of such foreign corporations were derived from sources without the United States even though the dividends were payable in this country, and there seems to be ground for the contention that it also applied with equal force whether the corporation was foreign or domestic. Under the present law it is provided (Revenue Act of 1918, § 213 (c)) that in the case of non-resident aliens "gross income includes only the gross income from sources within the United States, including * * * and including dividends from *resident* corporations." It may, therefore, be said that this language removes the doubt existing under the provisions of the 1916 Law, and places the taxability of non-resident aliens in respect to dividends on the ground of the residence of the corporation paying the dividends.

20 Reg. 45, Art. 92. The English law taxes an English company which has permanently located its business and seat of management abroad only with respect to the profits of the English shareholders.

21 Revenue Act of 1918, §§ 213 (c) and 216 (b).

22 Revenue Act of 1918, § 217.

23 Reg. 45, Art. 92.

or association, not engaged in business in the United States is exempt from all income and war-profits and excess-profits taxes.[24]

INTEREST ON BANK DEPOSITS. Where banking houses located in this country carry deposits for non-resident aliens, the interest thereon must be included in the non-resident alien's income tax return for the year in which he receives the interest or in which it is credited to an account against which he may draw.[25] The bank is required to withhold the normal tax of 8% on such interest when paid to non-resident aliens.[26]

SALARIES FOR EXTRA-TERRITORIAL SERVICES PAID BY RESIDENT EMPLOYERS. It is held that salaries, wages, and commissions paid by domestic business enterprises to non-resident alien employees for services rendered entirely in a foreign country are not subject to income tax in the hands of the recipient as from sources within the United States.[27]

WAGES OF ALIEN SEAMEN. While resident alien seamen are taxable like citizens on their entire income from whatever sources derived, non-resident alien seamen are taxable only on income from sources within the United States. Ordinarily, wages received for services rendered inside the territorial United States are to be regarded as from sources within the United States. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States, but wages earned by an alien seaman on a ship regularly engaged in foreign trade are not to be regarded as from sources within the United States, even

[24] Reg. 45, Art. 93; Act of July 9, 1918 (Public No. 192), Sec. 3, as amended by Act of March 3, 1919, § 4. This is true notwithstanding the provisions of the Second Liberty Bond Act (Act of September 24, 1917, Public No. 43), the Third Liberty Bond Act (Act of April 4, 1918, Public No. 120), and the War Finance Corporation Act (Act of April 5, 1918, Public No. 121).

[25] Reg. 45, Art. 91.

[26] T. D. 2652. Letter from Treasury Department dated February 4, 1918; I. T. S. 1918, ¶ 3077. Prior to the above ruling, banks were not required to withhold tax on such interest or to make any return of the amount paid thereon to any depositor. (Letter from Treasury Department dated June 29, 1917; I. T. S. 1918, ¶ 177.)

[27] Reg. 45, Art. 92. Under the 1913 Law it was held that compensation paid to non-resident aliens for services rendered in a foreign country, including business and traveling expenses, was not taxable. (T. D. 2152.) The 1916 Law by imposing a tax on "income from all sources within the United States" raised a question as to the taxability of such compensation. (Reg. 33, Rev., Art. 32.)

though the ship flies the American flag, or although during a part of the time the ship touched at United States ports and remained there a reasonable time for the transaction of its business. The presence of a seaman aboard a ship which enters a port for such purposes of foreign trade is merely transitory and wages earned during that period by a non-resident alien seaman are not taxable. There is no withholding from the wages of alien seamen unless they are non-residents.[28] An employer is, however, required to render a return of information in all cases where he has made payment of $1,000 or over of wages to resident alien seamen in any taxable year.[29]

INCOME RECEIVED FROM FIDUCIARIES. Where a non-resident alien is the beneficiary of a trust, or of the estate of a deceased person, or is the recipient of income from any property held by another, such income is taxable to the extent that it arises from sources within the United States. The intervention of an agent, trustee or other fiduciary between the non-resident alien and the source of the income does not render income subject to taxation, which otherwise would not be taxable, nor does it serve to relieve from taxation income which otherwise would be taxed.[30] Dividends, for instance, would not be subject to the normal tax for the reason that they are paid to a trustee and by him distributed to non-resident aliens.[31] Similarly, interest upon 4¾% notes of the Fifth Liberty Loan is not made taxable by passing through the hands of a fiduciary to the beneficiary.[32] One important class of exempt income from estates is gifts, legacies, bequests, etc., the principal thereof being exempt, but the income therefrom being taxable.[33]

[28] Reg. 45, Art. 92a. As to the status of alien seamen as residents or non-residents, see Reg. 45, Art. 312a and page 48.

[29] Letter from Treasury Department dated September 20, 1919; I. T. S. 1919, ¶ 3609.

[30] Letter from Treasury Department dated March 25, 1915; I. T. S. 1918, ¶ 110.

[31] Letter from Treasury Department dated April 5, 1916; I. T. S. 1918, ¶¶ 32, 62, and 873.

[32] Exempt income is not reported by the fiduciary as income accruing to the estate for the purpose of tax. See Revenue Act of 1918, §§ 219 (b), 212 (a) and 213.

[33] See Chapter 20. See also Revenue Act of 1918, § 213 (a) 3.

INCOME FROM PARTNERSHIPS. Non-resident aliens, who are members of partnerships deriving all their income from sources within this country, are taxable on their entire distributive shares.[34] If a partnership derives only part of its income from sources within the United States, non-resident alien partners are taxable only on that part of their respective distributive shares of the partnership profits which represent income of the partnership from such sources.[35]

INCOME FROM THE SALE OF PROPERTY. Non-resident aliens are taxable on profits and gains from the sale of real or personal property located in the United States.[36] Where sales of intangible personal property, for example, stocks, bonds, notes, etc., of domestic corporations or residents are made in the United States, the profit is held to be taxable and the custodian of the securities here is charged with the duty of reporting the profit of the non-resident alien, for which purpose he must place himself in possession of all the facts necessary to an accurate determination of the amount of profit in the transaction.[37] If a sale of such intangible personal property is made in a foreign country by a non-resident alien, it does not seem that the seller would be taxable on the gain or profit therefrom.

INCOME FROM ROYALTIES. Royalties paid to non-resident aliens under an agreement for the purchase of certain patent rights, the patents being based upon the quantity of goods produced by the use of such patents, have been held to be income accruing to non-resident aliens by reason of property owned or business carried on within the United States.[38]

INCOME FROM RENT. Rent paid to non-resident aliens by domestic business enterprises for property located in a foreign

[34] Revenue Act of 1918, § 218. See Chapters 8 and 9.

[35] This is one of the many questions on which the Treasury Department has not as yet made any clear public statement of its position. The status of a partner differs materially from that of a stockholder in a corporation, since in the case of a partnership no separate entity is interposed between the recipient of the income and its original source. See U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27.

[36] Revenue Act of 1918, § 213 (a) (c). See Chapter 17, for the method of computing taxable gains on the sale of property.

[37] Letter from Treasury Department dated May 31, 1916; I. T. S. 1918, ¶ 104.

[38] T. D. 2137; Reg. 45, Art. 91.

country is not subject to tax as income from a source within the United States.[39]

OTHER INCOME. Gains, profits and income from any source whatever in the United States (except exempt income) are taxable in the hands of non-resident aliens.[40] The questions which arise in this connection are with respect to the source[41] of the income, rather than with respect to its character. Many of the questions will be settled only by the slow and gradual process of development of the law, through litigation and by specific rulings of the Treasury Department on cases brought to its attention.[42]

Deductions Allowed in Computing Net Income. A non-resident alien is required to report all his taxable income from sources within this country, but from the gross amount so reported is entitled to make certain deductions before the tax is assessed on the remainder. The deductions are similar in kind to those allowed to residents and citizens but, in general, are confined to expenditures connected with the production of the income subject to tax as being from sources within the United States or limited by the proportion of the individual's income arising from sources within this country.[43] In the case of a non-resident alien individual the deduction for *interest* paid or accrued is proportionate to his income from sources within the United States; for *losses* incurred in any transaction entered into for profit, or arising from casualty or theft, is confined to transactions and property within the United States; for *charitable contributions* excludes gifts to foreign corporations, and includes gifts to domestic corporations and the Vocational Rehabilitation Fund;[44]

39 Reg. 45, Art. 92.

40 Revenue Act of 1918, § 213 (a).

41 The definition of the term "source" and some rulings throwing further light upon its meaning are discussed elsewhere in this chapter. See page 43.

42 It will be noted that § 213 (c) of the Revenue Act of 1918 goes further than the 1916 Law in expressly citing specific kinds of income as being "from sources within the United States," and Reg. 45, Art. 91 expand the definition beyond the law and all previous regulations. But the phrase "sources within the United States" is too broad and indefinite for practical certainty and it results in imposing the tax on incomes in cases where there is serious question as to the moral right or economic wisdom of so doing.

43 Revenue Act of 1918, § 214 (b).

44 Prior to the enactment of the Revenue Act of 1918 gifts or contributions were in no case deductible by non-resident aliens.

and for *business expenses, taxes* imposed by a foreign country, *losses in trade, bad debts, depreciation, amortization, depletion, and loss in inventory,* is allowed only if and to the extent that it is connected with income arising from a source within the United States.[45] An extended discussion of deductions is contained in other chapters,[46] the discussion in this chapter being limited to the provisions which apply particularly to non-resident aliens.

Business Expenses. Non-resident aliens may deduct from their gross income all ordinary and necessary expenses paid or incurred in carrying on any trade or business subject to the same general provisions applicable to citizens and residents.[47] Where the business or trade carried on in this country is by means of separate and distinct branches the expenses are readily determined. Where the accounts are kept at, and the business is under the supervision of, the home office abroad, the home office expenses connected therewith, if segregated, may be included. If not segregated, the Treasury Department has permitted the deduction of such proportion of the entire expenses of the business as the gross income from this country bears to the entire gross income from business done both within and without the United States.[48]

Credits. Non-resident aliens are permitted a credit of dividends for the purpose of the normal tax in certain cases. They are also permitted a credit for purposes of the normal tax of any interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[49] This subject is discussed elsewhere in this chapter.[50]

Credit of Tax Withheld at the Source. As the law requires the normal tax to be withheld by the one in this country who pays fixed or determinable and annual or periodical income to a non-resident alien,[51] a due credit for the amount so withheld may

45 Reg. 45, Art. 271.

46 See Chapters 21-30.

47 Revenue Act of 1918, § 214 (a) 1.

48 See Chapter 12.

49 Revenue Act of 1918, § 216. As to interest received after March 3, 1919, see page 46.

50 See page 46.

51 See Chapter 40.

be claimed by the non-resident alien in filing his annual return.[52] The non-resident alien should therefore keep a record of the amount of tax withheld at the source from time to time on payments made to him, and should report the aggregate sum so withheld in his return, in order that the normal tax may not be twice collected with respect to the same income.

PERSONAL EXEMPTION. A non-resident alien individual, similarly to a citizen or resident, is entitled for the purpose of the normal tax to a personal exemption, and to a credit of $200 for each dependent, except that if he is a citizen or subject of a country which imposes an income tax the personal exemption is allowed only if his country allows a similar credit to citizens of the United States not residing in such country.[53]

Returns. A non-resident alien individual must make or have made on his behalf a full and accurate return of income received from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source.[54] A non-resident alien may have had the tax on all his income arising from sources within this country withheld at the source although he may be taxable on a lesser amount by reason of expenses, interest, losses and other deductible items. Only by filing a return may he claim these deductions and secure the return to him of any amount withheld in excess of his tax liability. His return must include such information as may be deemed necessary by the Commissioner for the calculation of any deductions and credits to which he may be entitled. But, unless the country of which the non-resident alien is a subject or citizen imposes an income tax and does not allow a subject or citizen of the United States not residing therein a similar credit, the personal exemption and the credit for dependents may be allowed to non-resident aliens in the discretion of the Commissioner without the

52 Telegram from Treasury Department dated March 5, 1919; I. T. S. 1919, ¶ 3244.

53 The subject of the personal exemption, both as to citizens and residents and as to non-resident aliens, is fully treated in another chapter. See Chaper 31.

54 Revenue Act of 1918, § 223; Reg. 45, Art. 403. Form 1040C is used for this purpose. For the year 1918 the same form (Form No. 1040) was prescribed for the use of all individuals, resident and non-resident. A non-resident alien made such changes as were necessary to indicate that the return covered in his case only income from sources within this country. The

filing of the above return of income from all sources within the United States, these credits being received in such case by the filing of a claim therefor with the withholding agent.[55] The Commissioner has ruled, however, that for the present the benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a non-resident alien by filing a claim with the withholding agent, but only by claiming them upon filing a return of income. Unless a non-resident alien individual renders a return of income, the tax will as a general rule [56] be collected on the basis of his gross income (not his net income) from sources within the United States. Where a non-resident alien has various sources of income within the United States, so that from any one source or from all sources combined the amount of income calls for the assessment of a surtax, and a return of income is not filed by or on his behalf, the Commissioner will cause a return of income to be made, and include therein the income of such non-resident alien from all sources concerning which he has information, and he will assess the tax and collect it from one or more of the sources of income within the United States of such non-resident alien, without allowance of deductions or credits.[57] For the purpose of obtaining a refund of any amount withheld in excess of his tax liability as above indicated, a non-resident alien is required to attach to his return a statement showing accurately the amounts of tax withheld with the names and post office addresses of all withholding agents.[58] Upon the basis of such information the Treasury Department thereupon orders the withholding agent to release the excess withheld.[59]

Returns by Agents. If a non-resident alien is unable to make his own return, it may be made on his behalf by a duly authorized agent and in proper cases may also be made by guard-

additional information required in order to compute the amount of deductible interest (deductions and credits under the present law) was made on a supplementary statement attached to the return.

55 Revenue Act of 1918, § 217.

56 For the exceptions to this rule see Reg. 45, Art. 316 and T. D. 2811. The exceptions are discussed in Chapter 31.

57 Reg. 45, Art. 311.

58 Reg. 45, Art. 403; T. D. 2815.

59 Telegram from Treasury Department dated January 25, 1917; I. T. S. 1918, ¶ 91.

ians or other persons charged with the care of the person or property of such taxpayer.[60] It should be borne in mind that a non-resident alien may have an agent in this country for the purpose of making returns without having appointed one. The responsible representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States must make a return of such income, and must pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a non-resident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[61] Any individual, partnership or corporation having the control, receipt, custody, disposal or payment of fixed or determinable income payable to any non-resident alien, such income with certain exceptions being required to be withheld at the source, makes a return thereof on or before March 1st of each year and pays the tax due thereon on or before June 15th.[62]

WHERE FILED. A non-resident alien files his return in the district in which he has his principal place of business in this country, and if he has none, then with the Collector of Internal Revenue at Baltimore, Maryland.[63]

WHEN FILED. The return of a non-resident alien should be filed on or before March 15th or on or before the 15th day of the third month following the close of such non-resident's fiscal year, accordingly as he reports for income tax purposes on the basis of the calendar or a fiscal year.[64]

EXTENSION OF TIME. Non-resident aliens are allowed a reasonable extension of time for filing returns whenever in the judgment of the Commissioner good cause exists therefor.[65]

60 Revenue Act of 1918, § 223.
61 Reg. 45, Art. 403. See p. 56 for a discussion of this ruling.
62 Revenue Act of 1918, § 221. See Chapters 40 and 5.
63 Revenue Act of 1918, § 227 (b).
64 Revenue Act of 1918, § 227 (a).
65 Revenue Act of 1918, § 227 (a). See Chapter 34.

FAILURE TO FILE RETURN. In general, non-resident aliens are subject to the same penalties for failure to file returns as are citizens and residents.[66] In case of failure to file a return the collector will collect the tax on the income of a non-resident alien and all property in the United States belonging to such non-resident alien will be liable to distraint for the tax.[67]

Paying the Tax. Except in so far as the income tax payable by a non-resident alien is collected at the source[68] the general provisions in regard to the payment of income taxes apply to non-resident aliens as well as to citizens and residents. The tax is payable in four installments, the first installment being paid at the time the return is filed; the second installment on the 15th day of the third month; the third installment on the 15th day of the sixth month; and the fourth installment on the 15th day of the ninth month, after filing the return. This subject is discussed more fully in another chapter.[69]

Abatement and Refund. If upon the filing of the annual return it appears that the non-resident alien is liable for less tax than the amount which has been withheld at the source, the Treasury Department will issue instructions to the withholding agents (whose names and addresses should be given by the non-resident alien in his return) to release at once the proper amounts.[70] After the tax has been assessed against the withholding agents by the Government, abatement may be claimed, and after the tax has been paid, refund may be claimed, in the manner outlined in a later chapter.[71]

66 See Chapter 36.
67 Revenue Act of 1918, § 217.
68 See Chapter 40.
69 See Chapter 35.
70 Revenue Act of 1918, § 221 (d); Reg. 45, Art. 369. Telegram from Treasury Department dated January 25, 1917; I. T. S. 1918, ¶ 91.
71 See Chapter 37.

CHAPTER 5

RESIDENT AGENTS FOR NON-RESIDENT ALIENS AND FOREIGN CORPORATIONS—NOMINAL STOCKHOLDERS

The Revenue Act of 1918 expressly provides for the collection of the tax at the source on payment of certain specified forms of income to *non-resident aliens* and *non-resident foreign corporations.*[1] The persons required to withhold and account for the tax are designated in the law as withholding agents.[2] The Treasury Department, in addition, has followed under the present law a method of collecting the tax on income liable to pass out of its jurisdiction, which it evolved under the 1916 law and which consists in impressing upon residents, under certain circumstances, the duty of filing returns and paying the normal tax and the surtax on any and all income of non-resident *aliens* and non-resident foreign *corporations* over which they have custody or control.[3] Such persons are held to be agents of the non-residents and to stand in the place of their principals.[4] A withholding agent may or may not, depending on the circumstances, be an agent within the meaning of this chapter.[5]

Lack of Authority Under Present Law. The Revenue Act of 1918 does not contain any provision expressly making an agent liable for the surtax—or the normal tax upon income which is not both fixed or determinable and annual or periodical imposed upon his principal with respect to income passing through the hands of such agent.[6] The Commissioner has nevertheless ruled

1 Revenue Act of 1918, §§ 221, 237. Under the 1916 Law agents for foreign partnerships were not required to make any returns or pay any taxes for the foreign partnerships unless and until they were so instructed by the Commissioner. (T. D. 2401). This was because a partnership was not itself subject to tax or required to make returns.

2 Revenue Act of 1918, § 200. See Chapter 40.

3 Reg. 45, Art. 404.

4 Reg. 45, Art. 404; T. D. 2135.

5 See p. 57 for a discussion of this distinction.

6 Revenue Act of 1916, § 9 (g). The Treasury Department evidently based

that the responsible representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States, must make a return of such income, and must pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a non-resident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[7]

Distinction Between Withholding and Resident Agents. The distinction between withholding agents and resident agents may be indicated from two angles: (a) their respective services in securing to the government the payment of the income tax of non-resident alien individuals and non-resident foreign corporations and (b) the character of their respective relationships to the taxpayer for whose tax they are responsible. As appears more fully in a subsequent chapter, the provisions for the collection of the tax at the source apply only to the normal tax and then only in the case of income which is both (1) fixed or determinable *and* (2) annual or periodical.[8] Obviously, a large part of the income accruing to non-resident aliens and non-resident foreign corporations from sources within the United States is not both fixed or determinable *and* annual or periodical, and a large part would, because of its amount (combined or not with other items of income to the same recipient from sources within

its authority to impose upon resident agents the duties discussed in this chapter upon this section of the 1916 Law (T. D. 2452).

7 It may be argued that the Commissioner has authority under § 223 of the Revenue Act of 1918 which provides that "if a taxpayer is unable to make his own return, the return shall be made by a duly authorized agent * * * or other person charged with the care of the person or property of such taxpayer" to compel resident agents to *file returns* on behalf of their non-resident principals, but this section certainly gives no authority for imposing the duty to *pay any tax.* It seems clear that this deficiency of authority in the present law should be remedied by prompt amendment, since otherwise large sums of just taxes payable by non-resident aliens and non-resident foreign corporations may be lost to the government.

8 Reg. 45, Art. 362. See Chapter 40.

the United States) be liable to the surtax provided by the Revenue Act of 1918. The ordinary withholding provisions [9] of the present law therefore provide insufficient security for the collection of the *normal* tax upon the income of non-resident aliens and non-resident foreign corporations from sources within the United States and no security whatever for the collection of the *surtax* upon such income. The placing of a responsibility upon so-called resident agents fills this deficiency. Withholding agents insure the collection of the normal tax upon income which is both fixed or determinable and annual or periodical; resident agents insure the collection of the normal tax upon income not falling within these rigid classifications and of the surtax upon income without regard to any classification. The distinction between withholding agents and resident agents from the viewpoint of their respective relationships with the taxpayer is not so clear. A withholding agent is defined in the law [10] as "any person required to deduct and withhold any tax." In brief, a person is required to deduct and withhold the normal tax, in the case of non-resident aliens and non-resident foreign corporations, upon the payment of fixed or determinable and annual or periodical income.[11] The relationship of the withholding agent to the taxpayer whose tax is withheld is an artificial relationship and arises in all cases where the relationship of debtor and creditor exists and the parties contemplate payment in a certain manner. As a matter of fact, a withholding agent is primarily an agent of the government, not the taxpayer. On the other hand, a resident agent's status depends neither on the relationship of debtor and creditor nor on the manner of payment contemplated for the debt. Thus, a bank is not a resident agent for its non-resident depositors where the relationship is merely that of bank and depositor [12] (i. e. ordinarily debtor and creditor), but a bank acting as the custodian of securities on which it collects and disburses interest would be a resident agent.[13] In other words,

9 Revenue Act of 1918, §§ 221, 237.

10 Revenue Act of 1918, § 200.

11 Revenue Act of 1918, §§ 221, 237.

12 Reg. 33, Art. 67; letter from Treasury Department dated February 8, 1917; I. T. S. 1918, ¶ 106.

13 Letter from Treasury Department dated April 10, 1916; I. T. S. 1919, ¶ 560.

a resident agent is at least to some degree an agent of the taxpayer as well as of the government; and being an agent of the taxpayer, he must derive his appointment and authority from some act or conduct of the principal such as a power of attorney, or fiduciary status existing between himself and the taxpayer.[14]

Definition. In order to simplify the discussion in the following pages of this chapter the term "non-residents" will be used to include non-resident alien individuals and non-resident foreign corporations, i. e. foreign corporations having no office or place of business in this country.

Who are Resident Agents. A resident corporation, partnership or individual may be an agent within the meaning of this chapter. The following have been held to be such resident agents: (a) residents acting by power of attorney for non-residents; (b) responsible heads or representatives in charge of property owned or business carried on by non-residents in this country;[15] (c) resident nominal stockholders holding stock in their names for non-resident actual owners;[16] (d) residents having custody of securities of non-residents on which they collect the income, both with respect to the income and with respect to any profits made from the sale of the securities;[17] (e) residents purchasing patent rights from non-residents and paying royalty thereon;[18] (f) real-estate agents managing buildings owned by non-residents.[19]

Who are not Resident Agents. The following have been held not to be resident agents within the meaning of this chapter: (a) Corporations paying interest on their own bonds or dividends on their own stock to non-residents, bondholders or stockholders, although they are withholding agents for the purpose of collec-

[14] The following language of Reg. 45, Art. 404 should be noted in this connection: "The agency *appointment* will determine how completely the agent is substituted for the principal for tax purposes." (See also Reg. 33, Rev., Art. 32.)

[15] Reg. 33, Art. 8; T. D. 2313.

[16] See p. 62.

[17] Letter from Treasury Department dated May 31, 1916; I. T. S. 1918, ¶ 105. For the purpose of reporting profits made from the sale of the securities such agents are required to obtain all facts necessary to ascertain the profit in any transaction.

[18] T. D. 2137.

[19] Letter from Treasury Department dated January 19, 1915; I. T. S. 1918, ¶ 99.

tion of the tax at the source; (b) resident debtors, individual or partnership, although they are required to withhold the tax at the source on interest paid to non-resident aliens; (c) banks, where their relation to their non-resident depositors is merely that of bank and depositor;[20] (d) banks receiving interest or dividends direct from domestic corporations to be credited to the accounts of non-resident depositors;[21] (e) banks holding for the account of foreign banks and bankers securities on which they collect and disburse interest to the foreign banks and bankers;[22] (f) an individual, partnership, or corporation, occupying or standing in the ordinary relation of broker towards a non-resident as client, although he or it may be required to withhold the tax as a withholding agent.[23]

Duties and Liabilities of Resident Agents. The responsible heads or representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States, are required to make a return of such income and to pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the income tax on income so in their receipt, custody, or control shall not have been withheld at the source.[24] They are under no duty to inquire into or report any income of the non-resident principal received from other sources in this country, but may, if authorized by the non-resident principal, make a complete return of all income from sources within this country. Where the same non-resident

20 Banks are held not to be withholding agents with respect to interest paid on deposits. (Reg. 33, Art. 67.)

21 Letter from Treasury Department dated February 8, 1917; I. T. S. 1918, ¶ 106.

22 Letter from Treasury Department dated April 10, 1916; I. T. S. 1919, ¶ 560. Where the bank however acts as custodian of securities for non-residents other than banks it seems that it is a resident agent. Rulings however are not clear or consistent on this point.

23 Letter from Treasury Department dated April 17, 1918; I. T. S. 1919, ¶ 551. In the hypothetical case upon which this ruling was based the non-resident client maintained an account with the broker, occasionally buying some securities on margin and selling some from time to time, interest being charged on balances due and dividends as paid on the stocks carried and credited to the account. All dealings were in response to directions from the non-resident.

24 Reg. 45, Art. 404; Reg. 33 Rev., Art. 32.

has several agents, none of whom is authorized to make a return of all the principal's income, each agent reports separately the income coming into his hands, and the Treasury Department takes into consideration the aggregate amount of net income covered by all of the returns, in assessing the tax, making a further assessment to cover any surtax which may be due, in the case of individuals, on the aggregate income.[25] Of course, if the non-resident principal files a return of all his income from sources within this country, the agents are not also required to file returns. Resident agents, therefore, ascertain in due time whether or not their non-resident principals intend to report their income from sources within the United States and to pay the tax due thereon, and govern themselves accordingly.

Procedure in Collecting Income for Non-Residents. In collecting income subject to withholding of the tax at the source; the resident agent is required to execute the ownership certificate required of his non-resident principal, signing it with the name of the principal and affixing his own signature as agent.[26] In brief, with respect to such income, he is required to proceed as if he were the non-resident principal, in whose place he stands for the purpose of the income tax. The fact that the non-resident has an agent here does not relieve his income from withholding at the source when paid to such agent.

Making Returns for Non-Resident Principal. In making the annual return for his non-resident principal a resident agent is required to use the same form as would be used by the principal[27] and follow the provisions of the law and the regulations relating to non-resident aliens or foreign corporations, as the case may be, in claiming deductions. In the affidavit at the end of the individual's form, to be executed by the agent, a statement is required to be made that the return covers only the income received by the agent, or that it covers all the income of the principal from sources within the United States, as the case may be. The affidavit on the corporation's form is prepared for

[25] Letter from Treasury Department dated March 6, 1917; I. T. S. 1918, ¶ 114.

[26] See Chapter 40.

[27] Form No. 1040C, in the case of individuals; Form 1120 in the case of corporations.

execution by two officers of the corporation, when the return is signed by an agent for a foreign corporation, an affidavit that he is the properly authorized agent, and that the report covers income from all sources within the United States, or income passing through his hands, as the case may be, is required to be attached to the return and duly executed. The return may be filed in the district in which the agent resides or has his principal place of business.

Paying the Tax for Non-Resident Principal. The tax of a non-resident becomes due and payable at the same time and in the same manner as the tax of a resident, and may be paid in the same way.[28] Upon paying the tax, the agent may demand a separate receipt for the amount paid on behalf of his non-resident principal, and such receipt is sufficient evidence to justify the agent in withholding the amount therein stated from his next payment to the principal, if he has not already withheld an amount sufficient to satisfy the tax. The principal may demand this receipt from the agent upon giving him a full written receipt acknowledging the payment of the tax as a satisfaction of the agent's debt to that extent.[29]

Nominal Stockholders. For convenience in handling financial transactions, stock certificates are sometimes issued in the names of others than the actual owners of the stock. The individuals, partnerships or corporations so holding the nominal title to the

[28] A special ruling was made to cover cases in 1916, where the agent for a non-resident alien had received income from corporate interest or dividends and paid the same over to his principal prior to September 8th. In such cases, if the agent did not have, between September 8th and the end of the year, any income of the non-resident alien from which to pay the tax he was relieved from liability, leaving the tax a charge against the non-resident alien to be collected direct from him by the Treasury Department. (T. D. 2402.) A like special ruling was made to cover cases in 1917 where the agent for a non-resident alien had received income and paid the same over to his principal prior to October 3, but where the agent received the income of his principal subsequent to October 3 he was obliged to pay the total tax due for the entire year 1917 and subsequent years. (Reg. 33 Rev., Art. 32.) As the present law did not go into effect until February 25, 1919, the agent will undoubtedly only be held for tax on income passing through his hands up to that date, at the rates prescribed by the Revenue Act of 1916. (See Reg. 45, Art. 361, where this situation is treated in connection with the collection of the tax at the source.)

[29] Revenue Act of 1918, § 251.

stock are known as nominal stockholders or stockholders of record.[30] A nominal stockholder is not a withholding agent, although under the 1916 Law he might have been one if the actual owner was a non-resident foreign corporation. The distinction between a nominal stockholder and a fiduciary lies in the fact that the latter holds legal title to stock (if that is the subject of the trust), while a nominal stockholder may hold no title at all, the stock merely standing in his name on the books of the corporation. Nominal stockholders may acquire their status by arrangement with the actual owners, as where a broker carries in his name the stock of a customer, in which event the name and status of the actual owner is known; but in some cases the names of the actual owners may not be known to the nominal stockholder as, for instance, where the actual ownership is evidenced by bearer certificates.[31] In other cases, notably when large amounts of stock are left in the names of stock exchange houses, one may become a nominal stockholder without knowing the identity of the actual owner. Thus, stock certificates endorsed in blank by an actual owner, and sold on the market, may pass by delivery to several consecutive purchasers before the stock is transferred on the books of the corporation. In such cases, the original transferor remains the record owner until the transfer is made on the corporate books, and, as such, he is presumed to be the real owner of dividends declared on the stock, unless he proves that actual ownership of the stock does not rest in him.[32] If, however, a nominal stockholder not only parts with the certificate of stock, endorsed in blank, but also gives the corporation a "dividend order" to pay dividends to another, his responsibility for tax on such dividends ceases, and the one to whom the corporation pays the dividend becomes liable for any tax thereon, unless he in turn shows that actual ownership does not rest in him. A nominal stockholder receiving dividends and paying them over to one claiming to be the actual owner is re-

30 They are generally called "record owner" in the regulations. See Reg. 45, Art. 405.

31 The procedure under the 1916 Law applicable to such situations is indicated at the end of this chapter.

32 Letter from Treasury Department dated Deember 28, 1916; I. T. S. 1918, ¶ 274.

quired to ascertain the name and address of such claimant and proceed as indicated below.[33]

APPLICATION OF 1918 LAW TO NOMINAL STOCKHOLDERS. The Treasury Department based its authority for the rules and regulations issued under the 1916 Law in regard to withholding on dividend income against non-resident foreign *corporations* on the basis of apparent ownership, upon the provision [34] of the 1916 Law that "all the provisions of this title relating to the tax authorized and required to be deducted and withheld and paid to the officer of the United States Government authorized to receive the same from the income of non-resident alien individuals from sources within the United States shall be made applicable to income derived from dividends upon the capital stock or from the net earnings of domestic or other resident corporations, joint-stock companies or associations, and insurance companies by non-resident alien companies, corporations, joint-stock companies, or associations, and insurance companies not engaged in business or trade within the United States and not having any office or place of business therein." This provision was separate from and additional to the general withholding provision [35] of the 1916 Law which expressly excepted from its scope "income derived from dividends on capital stock, or from the net earnings of a corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title." The Treasury Department based its authority for requiring the tax to be paid on dividend income of non-resident alien individuals by nominal stockholders or record owners upon the provision [36] of the 1916 Law that "the intent and purpose of this title is that all gains, profits, and income of a taxable class, as defined by this title, shall be charged and assessed with the corresponding tax, normal and additional, prescribed by this title, and said tax shall be paid by the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same." The general withholding provision [37] of

[33] The regulations on this subject refer only to dividends of domestic corporations and resident foreign corporations. Reg. 45, Art. 404.

[34] Revenue Act of 1916, § 13 (f).

[35] Revenue Act of 1916, § 9 (b).

[36] Revenue Act of 1916, § 9 (g).

[37] Revenue Act of 1918, §§ 221 and 237.

the Revenue Act of 1918 expressly excepts from its scope "income received as dividends from a corporation which is taxable under this title on its net income," and contains no provision corresponding to the provision of the 1916 Law quoted above applying its general withholding requirements to income derived from dividends received by non-resident foreign *corporations* or making an agent liable for the surtax imposed upon his principal with respect to income *passing through the hands of such agent.* The reason for the failure of the present law to provide for withholding against non-resident foreign *corporations* as to income derived from dividends is that foreign corporations, as well as domestic corporations, are now entitled to deduct from gross income, in computing net income, "amounts received as dividends from a corporation which is taxable upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by act of Congress."[38] Under the present law no withholding from corporate dividends is required in any case,[39] and the responsibility of a nominal stockholder pertains only to the surtax for which a non-resident individual actual owner may be liable. He is a resident agent within the meaning of this chapter as to dividend income, but since the dividends of domestic or resident corporations are in no case subject to the normal tax, his liability is somewhat narrower than the liability of other resident agents.[40]

PROCEDURE WHEN NOMINAL STOCKHOLDER IS A RESIDENT AND ACTUAL OWNER IS A RESIDENT. In cases where both the nominal stockholder and the actual owner are residents of the United States, the nominal stockholder is not required to obtain any certificate disclosing the name of the actual owner. The primary purpose of requiring disclosure of the actual owner is to assist in administering that provision of the law which makes dividends on the stock of domestic or resident foreign corporations liable to surtax when paid to non-resident alien individuals.[41] The

[38] Revenue Act of 1918, § 234 (a) 6 and (b). Reg. 45, Art. 363.

[39] See p. 56 in regard to the deficiency of authority in the Commissioner under the present law in this connection.

[40] See letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶ 272, dealing with the 1916 law.

[41] Letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶ 272.

actual owner is, of course, in all cases obligated to report the dividends and pay the surtax thereon, if he is liable; the nominal stockholder is under no duty to report the dividends as his income but should be prepared to show conclusively, if question arises, that actual ownership does not rest in him.[42] If a nominal stockholder pays over the dividends to a resident whom he knows to be the agent of a non-resident alien, he is under no duty as agent, since it is the one who collects the dividend for a non-resident, or who finally pays it over to a non-resident, who has impressed upon him the duty of a resident agent.

PROCEDURE WHERE NOMINAL STOCKHOLDER IS RESIDENT AND ACTUAL OWNER IS NON-RESIDENT.[43] In this case it is immaterial whether the nominal stockholder is an individual, partnership, or corporation, since irrespective of his or its individual or corporate status, the nominal stockholder may be held responsible as resident agent for the surtax payable by the actual owner upon dividends. It is ruled under the 1918 Law that in all cases where the actual owner is a non-resident alien *individual* and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any *surtax* found by such return to be due.[44] If the actual owner is an individual, the return made by the nominal stockholder on his behalf may show that a surtax is due, since individuals are liable to the surtax. If, however, the actual owner is a partnership or corporation, the return made by the nominal stockholder on its behalf will not show any surtax to be due, since partnerships are not subject to any income tax as such,[45] and corporations are not liable to the surtax.[46]

[42] Letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶ 272.

[43] For the procedure under the 1916 Law see Reg. 33 Rev., Arts. 32 and 201; T. D. 2301; letter from Treasury Department dated June 6, 1918, I. T. S. 1918, ¶ 3528.

[44] Reg. 45, Art. 405.

[45] Revenue Act of 1918, § 218.

[46] Reg. 33, Art. 185.

PROCEDURE WHERE NOMINAL STOCKHOLDER IS NON-RESIDENT AND ACTUAL OWNER IS RESIDENT.[47] In this case, whether the actual owner is an individual, partnership, or corporation is immaterial, since the *residence* of the actual owner within the United States dispenses with the necessity of impressing the duty of the resident agent on the nominal stockholder. It is ruled under the 1918 Law that dividends on the stock of domestic or resident foreign corporations are *prima facie* income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure [48] of the actual ownership is made to the Commissioner which shall show that the record owner is not the actual owner and who the owner is and his address.[49] If the nominal stockholder is an individual and fails to make this disclosure, the dividends will, therefore, be subject to surtax as if they belonged to the individual nominal stockholder. If the nominal stockholder is a partnership, and fails to make such disclosure, the dividends will be regarded as income [50] of the partnership, to be reported in the information return of the partnership, and such dividends will ultimately be subject to surtax in the hands of the individual partners. If the nominal stockholder is a corporation and fails to make such disclosure, the dividends will be regarded as income of the corporation. But since dividends paid by domestic or resident foreign corporations are deductible from gross income when received by corporations, domestic or foreign,[51] they will not be *taxable* income in this event and it follows that a corporation need not make such disclosure.

PROCEDURE IN CASE OF DUTCH ADMINISTRATION OFFICES. Under the 1916 Law a special ruling having application to many similar situations in foreign countries was made with respect to the so-called "Administration Offices" in Holland. It appears that the Dutch Administration Offices are the registered owners of large blocks of American stocks, against which they have issued bearer certificates, with coupons attached. These coupons, upon presentation and surrender, entitle the bearer to dividends

47 See Note 43.

48 This disclosure is made on Form No. 1087 (revised).

49 Reg. 45, Art. 405.

50 See Revenue Act of 1918, § 224.

51 Revenue Act of 1918, § 234 (a) 6, (b).

declared on the stocks. The Administration Offices were held to be prima facie liable for the tax on dividends paid on the stock standing in their names, unless they disclosed the names of the actual owners by use of the proper certificates.[52] By appointing an agent in the United States they could avoid having the tax withheld at the source. Such agent was required to make returns of income for the Dutch Administration Office represented by him and pay the corporation tax of 2% on all dividends received by it, except such amounts as were shown by certificates disclosing actual ownership to have been received for the account of non-resident alien individuals or partnerships. Such certificates were attached to and made the basis of the return when filed.[53]

CERTIFICATES ISSUED TO BEARER. When stock of an American corporation is floated in some European countries, where investors are accustomed to bearer stock certificates, a block of the stock is sometimes issued to a trust company *in this country* which in turn issues bearer certificates entitling the holder to certificates of stock for the number of shares designated, upon the surrender of the bearer certificates, and to any dividends which may be declared on such shares while the bearer certificate is outstanding. The bearer certificates pass by delivery, the dividends being claimed through foreign banks by presentation and surrender of numbered coupons, attached thereto. In such cases the trust company was, under the 1916 Law, in the position of a resident nominal stockholder. Under the 1918 Law the rule would still seem to apply, and where the actual owner is a non-resident alien individual the trust company will be required to make return for such actual owner and pay the surtax found to be due.[54]

52 Disclosure was made on Form No. 1087.

53 T. D. 2386; T. D. 2669. This ruling was based on the theory that the Dutch Administration offices were "non-resident alien corporations," subject to tax on dividends and to having the tax withheld at the source. Since the Revenue Act of 1918 does not tax corporations on dividends received by them, it seems that only on some other theory can they be required to ascertain and disclose the names of the owners of their bearer certificates, under the present law. Neither the law nor the latest regulations have provided for the case of a foreign corporation nominal stockholder and a non-resident alien actual owner.

54 See Reg. 45, Art. 405. Form 1087 should be used to disclose actual ownership when the owner is a non-resident alien.

CHAPTER 6

FIDUCIARIES

The Revenue Act of 1918 has in general clarified rather than changed the provisions of the 1916 Law fixing the special duties and responsibilities of fiduciaries. Fiduciaries are classed as individuals under the law, irrespective of their status, individual or corporate, and may be required to make returns of income or returns of information, according to the character of their relationship with their beneficiaries or the nature of the income constituting the subject of the trust. In certain cases trust estates are taxed as entities in which cases the fiduciary is required to pay the tax for the estate; in other cases the law, ignoring the entity of the trust estate, taxes the income in the hands of the beneficiary, in which event the fiduciary is not required to pay any tax upon the estate. The provisions of law and regulations pertaining particularly to fiduciaries and trust estates are indicated below.

Who Are Fiduciaries. The Revenue Act of 1918 defines the term "fiduciary" to mean a "guardian, trustee, executor, administrator, receiver, conservator, or any *person* acting in any fiduciary capacity for any person, trust or estate."[1] In view of the definition of the word "person" used in this definition,[2] a corporation, partnership, joint-stock company or insurance company may be a fiduciary under the law. It has been held that a fiduciary for income tax purposes is one who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest,[3] or receives and controls the income of another, as in the case of receivers or minors. It has also been ruled that the term "fiduciary" applies to all persons or

[1] Revenue Act of 1918, § 200.

[2] In Revenue Act of 1918, § 1, the term "person" is defined to include "partnerships and corporations, as well as individuals." The term "corporation" includes associations, joint-stock companies, and insurance companies.

[3] Reg. 45, Art. 1521; T. D. 2090.

corporations who occupy positions of peculiar confidence towards others, such as trustees, executors, or administrators.[4] Some rulings and regulations issued in explanation of the term "fiduciary" are given below as indicative of the Treasury Department's attitude in interpretation of the broad term "any person acting in any fiduciary capacity for any person, trust or estate."

AGENTS. An agent, as such, is not a fiduciary for his principal even though he may have complete charge of the property of his principal.[5] There may be a fiduciary relationship between an agent and a principal, but the word "agent" standing alone does not denote a fiduciary within the meaning of the law.[6]

POWER OF ATTORNEY. A person cannot, by power of attorney, appoint another to act as a fiduciary. A power of attorney cannot create a fiduciary relationship. An agent having entire charge of property with authority conferred upon him by a power of attorney to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, paying taxes and expenses and all other charges in connection with the property out of funds in his hands from the rents collected, merely turning over the net profits from the property periodically to his principal is not a fiduciary. In cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability under the law to make returns and pay the taxes rests with the principal.[7]

GUARDIANS. A legal guardian is a fiduciary, but it does not seem that a natural guardian comes within the definition. Under the Revenue Act of 1918 minors are required to file returns, but if a minor is dependent upon his parent, who appropriates or may appropriate his earnings, such earnings are income of the parent and not of the minor for the purpose of the normal tax and surtax. In the absence of proof to the contrary a parent will be assumed not to have emancipated his minor child and must include in his return any earnings of the minor.[8] It seems, therefore, that if a minor exercises independent control of any of his own income, the guardian should not make a separate

4 Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29.
5 Reg. 45, Art. 1522; T. D. 2135.
6 Reg. 45, Art. 1522; Reg. 33 Rev., Art. 29; T. D. 2090.
7 Reg. 45, Art. 1522; Reg. 33 Rev., Art. 29; T. D. 2137.
8 Reg. 45, Art. 403.

return for the minor of income from a separate estate nor should the parent include the minor's income in his own return.

ANCILLARY ADMINISTRATOR. An ancillary administrator is merely an agent of the domiciliary administrator and should transmit to him all information as to income of the estate received by the ancillary administrator, to the end that the original administrator may make a return covering the entire income of the estate.[9]

RECEIVERS. A receiver for an individual is a fiduciary, but it seems that a receiver for a corporation is not,[10] notwithstanding the broad definition [11] of the words "fiduciary" and "person" and the general provisions of the law [12] governing fiduciaries.[13] Receivers appointed by authority of law, in possession of part only of the property of an individual, are expressly excepted from the requirements that fiduciaries make returns.[14]

TEMPORARY RECEIVER HELD TO BE FIDUCIARY. Under the 1916 Law it was held that one appointed under interlocutory orders of the United States District Court to act as receiver of an individual in a proceeding wherein certain persons complaining as creditors were seeking to have the property of the individual distributed among them, was a fiduciary, notwithstanding that title to the property in question (cash and securities) remained in the individual sued and that his possession and right to deal with the same were only suspended. The receiver, having received income from the property in his possession, was required to file a return as a fiduciary.[15]

9 Reg. 33 Rev., Art. 180.

10 Reg. 45, Art. 424. See letter from Treasury Department dated February 27, 1915; I. T. S. 1917, ¶ 597, and letter from Treasury Department dated June 22, 1916; I. T. S. 1918, ¶ 1097.

11 Revenue Act of 1918, § 1,200.

12 Revenue Act of 1918, § 225.

13 This is true because it is specifically provided elsewhere that receivers, trustees in bankruptcy, or assignees operating the property or business of corporations shall make returns for such corporations in the same manner and form as corporations are required to make returns and that any tax due on the basis of such returns will be collected in the same manner as if collected from the corporations of whose business or property they have custody and control. (Revenue Act of 1918, § 239.)

14 Revenue Act of 1918, § 225.

15 Letter from Treasury Department dated January 22, 1917.

MORTGAGE FORECLOSURE RECEIVERS. A receiver, appointed in a mortgage foreclosure action in the State of New York by a court of equity in aid of its jurisdiction, who is not a receiver of all the property of the mortgagor corporation, but is a common law receiver in charge of only a part of the mortgaged property of the corporation and a receiver merely of the rents and profits of such mortgaged property, need not file a return of income but he is required to file a return of information at the source.[16]

COMMITTEE FOR AN INCOMPETENT. The committee for the property of an incompetent person is regarded as a fiduciary.[17]

DEEDS OF TRUST. A deed of trust must be absolute so far as the conveyance of title is concerned and irrevocable by the donor, otherwise the income from the property in question will accrue to the donor and must be accounted for by him.[18]

Who Are Beneficiaries. A beneficiary within the meaning of the law and regulations and in the sense used in this book is the ward, *cestui que trust*, legatee, distributee, creditor, or other person entitled to any part of the net income of a trust or estate in the charge of a fiduciary. The trust estate itself is the beneficiary with respect to (1) income received by estates of deceased persons during the period of administration or settlement of the estate and not properly credited to any legatee, heir, or other beneficiary; (2) income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests; (3) income held for future distribution under the terms of the will or trust.[19]

16 Reg. 45, Art. 424; Letter from Treasury Department dated May 1, 1918; I. T. S. 1919, ¶ 1433. This letter stated that the same ruling extended to receivers of partnerships under the excess profits tax. It was first held by the Treasury Department under the 1916 Law that a receiver in foreclosure proceedings of the rents, issues and profits of mortgaged premises, even though for only a part of the property of the mortgagor, was required to file a return of income reporting the entire operations transacted by the receiver during the year 1917. Upon further consideration the Treasury Department changed this ruling to that stated in the text above. (Letter from Treasury Department dated March 28, 1918; I. T. S. 1918, ¶ 3293.)

17 Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29. Letter from Treasury Department dated February 21, 1916; I. T. S. 1918, ¶ 128; letter from Treasury Department dated May 1, 1918; I. T. S. 1919, ¶ 1433.

18 Reg. 45, Art. 341; Reg. 33 Rev., Art. 29.

19 See Revenue Act of 1918, § 219.

Duties of Fiduciaries Generally. Every fiduciary is required by the law to make under oath a return for the individual, estate or trust for which he acts.[30] This return may be of two kinds: (a) a return of *income,* or (b) a return of *information,* according to the nature of the income constituting the subject of the trust. If the income is (1) received by estates of deceased persons during the period of administration or settlement,[31] and not properly paid or credited to any legatee, heir, or other beneficiary during that period, (2) accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or (3) held for future distribution under the terms of the will or trust, the return is one of *income.* If the income (4) is to be distributed to the beneficiaries periodically, whether or not at regular intervals, (5) is collected by the guardian of an infant to be held or distributed as the court may direct, or (6) is properly paid or credited to any legatee, heir, or other beneficiary during the period of administration or settlement of an estate, the fiduciary's return is merely an *information* return. It is the duty of every fiduciary who is required to make a return of *income* to pay the tax computed in the return to be due. Cases in which the fiduciary is required to *pay the tax* are divided into two classes: (1) cases in which, by reason of the nature of the income constituting the subject of the trust, the tax is imposed upon the trust estate as an entity and the fiduciary's return is one of income, and (2) cases in which the fiduciary's return is merely one of information but, by reason of the status of the beneficiary, the tax, although laid upon the beneficiary, must be paid by the fiduciary on his behalf.

DUTIES OF RECEIVERS. Receivers who, as officers of a court, stand in the stead of some principal, are required to account for income tax as the principal would be required to account.[32]

[30] Revenue Act of 1918, § 225.

[31] The "period of administration or settlement of the estate" is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. (Reg. 45, Art. 343.)

[32] Reg. 45, Art. 424; Reg. 33 Rev., Art. 26. Form No. 1040 (revised) or 1040A (revised) is used by a receiver for an individual. The 1916 Law con-

Where a receiver for an individual, acting under interlocutory orders of the court, receives income during any year or funds which he holds in trust as such receiver, such income must be accounted for and the tax paid thereon for that year. Having been thus freed from tax liability, the income assumes the status of capital and may thereafter be distributed by the receiver in the same manner as other capital. The fact that all or any part of the income received by a receiver may be used to pay creditors does not relieve the receiver from first paying the tax on all income received by him, since the Government has a prior lien for the amount of the tax and only what remains after the tax is paid may be distributed to creditors or others.[23]

Duties of Executors and Administrators. In addition to the duties of fiduciaries generally, executors and administrators are charged with the duty of making returns of income of the decedent for the period during which he lived and made no return prior to his death.[24]

Income of Estates and Trusts. The income of estates and trusts received during any taxable year is subject to tax either (a) in the hands of the beneficiaries on their respective shares paid or credited to them by the fiduciary during the year or (b) in the hands of the fiduciary, if the income is not paid or credited to a beneficiary. In other words, all or a part of the net income of an estate or trust may be distributable to beneficiaries[25] and if

tained a general provision (Revenue Act of 1916, § 9 (g)) which charged all gains, profits and income of a taxable class with the corresponding tax, and provided further that such tax should be paid by "the owner of such income. or the proper representative having the receipt, custody, control, or disposal of the same." The Revenue Act of 1918 contains no similar provision. However strong the implication may be that receivers are to pay the tax on income of the persons for whom they act, the absence of a mandatory provision imposing this duty and indemnifying them against all claims and demands of every beneficiary for all payments of taxes they are required to make, may place receivers in embarrassing situations, since they are held rigidly to account for all their acts, and any moneys paid out under doubtful authority may involve them in personal liability. The same considerations apply to guardians.

23 Letter from Treasury Department dated February 9, 1917; I. T. S. 1919, ¶ 1242.

24 See p. 89 for a more complete statement of this liability.

25 Income to be distributed to beneficiaries periodically, whether or not at regular intervals, income collected by the guardian of an infant to be held or distributed as the court may direct, or income properly paid or credited to

so there is to be included in computing the net income of each beneficiary his distributive share, whether distributed or not, and the fiduciary is required to make a return showing the net income of the estate or trust and the distributable shares of each beneficiary. The fiduciary's return is one of information and he is not required to pay any tax unless the beneficiary is a non-resident alien, a minor, an incompetent, or otherwise incapacitated. On the other hand, all or a part of the net income of an estate or trust may be retained for future distribution and at the end of the year added to the corpus of the estate.[26] Such income is taxed to the fiduciary and he is required to file a return showing the amount thereof and the tax due thereon, just as individuals are required to report income and pay the tax.[27] If part of the income is distributable and part is retained by the estate, the tax is imposed on the respective parts as above indicated.

Gross Income of Estates and Trusts. The gross income of an estate or trust embraces income from all sources, as in the case of individuals.[28] All income derived from its corpus or capital is income to the estate or trust. The corpus, that is, the amount of capital transferred to the estate at the time of its creation, is not income. Thus, in the case of estates of deceased persons, the appraised value of the property at the time of the death of the decedent is capital, regardless of the fact that the cost of that property to the decedent may have been less than such appraised value.[29] Similarly, the value of the property constituting the subject of a trust at the time the trust is created is its capital. Income received by a decedent before his death is capital when received by the estate. Where during the period of administration an executor converts the estate in his possession into money

beneficiaries during the period of administration or settlement of an estate is here referred to.

26 Income received by estates of deceased persons during the period of administration or settlement (not paid or credited as indicated in note 25), income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or income held for future distribution under the terms of the will or trust, is here referred to.

27 Revenue Act of 1918, § 219; Reg. 45, Arts. 341 to 346 incl. and Arts. 421 to 425 incl.

28 Revenue Act of 1918, § 219 (a).

29 Telegram from Treasury Department, dated February 3, 1917; I. T. S. 1919, ¶ 1183; Reg. 45, Art. 343.

for the purpose of settling the estate and closing the administration, the gain or loss on the sale of such property is determined by deducting from the selling price (or vice versa) the appraised value of the property at the time of the death of the decedent or, if the estate was created prior to March 1, 1913, the fair market price or value on that date.[30] If the corpus of an estate or trust is delivered in kind to beneficiaries no income is realized by the estate or trust although the value of the property when delivered may be greater than its appraised value at the time of its transfer to the estate or trust.[31] The rules laid down by the courts with respect to the distinction between income and capital in cases involving the respective rights of life-tenant and remainderman do not necessarily apply under the provisions of the income tax law, so far as assessing the tax is concerned.[32] Thus, extraordinary dividends received by an estate are held to be income to the same extent as if received by an individual, although a part of the surplus or undivided profits from which the dividends are declared may have been earned by the corporation prior to the creation of the estate. As an intestate's real estate does not pass to his administrator, upon a sale by the heirs, whether before or after settlement of the estate, each heir is taxed individually on any profit derived.[33] The income of a revocable trust must be included in the gross income of the grantor.[34]

Income Constructively Received by Decedent Prior to Death. Where dividends are declared on stock and interest accrues on bonds and mortgages during the lifetime of a decedent keeping his accounts upon a cash receipt and disbursement basis, but such dividends and interest are not paid until after his death, the dividends are income of the decedent when credited to or set apart for him, although not collected prior to his death. If the interest is upon matured coupons not cashed, but nevertheless available to the decedent prior to his death, it is constructively received when made available. If the interest is mortgage interest, it should be included in the decedent's gross income for

30 Reg. 45, Art. 343.
31 See Reg. 45, Art. 343.
32 See Trefry v. Putnam, (Mass.) 116 N. E. 904.
33 Reg. 45, Art. 342.
34 Reg. 45, Art. 341.

the year in which it becomes due and payable.[35] It follows that such dividend and interest income, having been constructively received by the decedent during his lifetime, should be treated as capital of the estate, and will not be taxable in the hands of his estate.

PROCEEDS OF LIFE INSURANCE POLICIES. The proceeds of life insurance policies paid to an estate upon the death of the insured are exempt from income tax under the present law.[36]

LIBERTY BOND EXEMPTION IN CASE OF ESTATES AND TRUSTS. When income is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. In such a case a subscription by a trustee for bonds of the Fourth Liberty Loan, or notes of the Victory Liberty Loan, constitutes each beneficiary existing at the time of such subscription an original subscriber for his proportionate part of such bonds or notes, as the case may be, and entitles such beneficiary to the appropriate collateral exemption of interest on bonds of previous issues, whether owned by such beneficiary or by the trustee, as if the beneficiary had himself originally subscribed for such proportionate part of the bonds or notes; and a subscription by such beneficiary for bonds of the Fourth Liberty Loan or notes of the Victory Liberty Loan, as the case may be, entitles him to the appropriate collateral exemption of interest on bonds of previous issues held by the trustee. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to

35 Letter from Treasury Department dated May 31, 1919; I. T. S. 1919, ¶ 3407.

36 Revenue Act of 1918, § 213 (b) 1. Under the 1916 Law the proceeds of life insurance policies were exempt only if paid to *individual beneficiaries* (Revenue Act of 1916, § 4; Act of October 3, 1913, B). Under the 1916 Law the proceeds of life insurance policies payable to the estate of a decedent, when received by an executor or administrator, were, in the amount by which they exceeded the premium or premiums paid by the decedent, income of the estate, to be accounted for by the executor or administrator. (Reg. 33 Rev., Art. 29.)

exemption on account of such ownership. In such a case a subscription by a trustee constitutes the trustee as such the original subscriber and entitles the trust, on account of such subscription, to the collateral exemption of interest on bonds of previous issues.[37]

Deductions Allowed to Estates and Trusts. In computing the net income of trust estates the statute allows the same deductions as are allowed to individuals with the exception indicated in the next following paragraph.[38] The Treasury Department, however, has made several special rulings with respect to the deductions which may be claimed by fiduciaries against the income of estates or trusts and these rulings are given in the succeeding paragraphs.

CONTRIBUTIONS TO CHARITIES. In lieu of the deduction authorized in the case of citizens or residents for charitable contributions, trust estates are allowed to deduct any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any corporation or association organized and operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual.[39]

BUSINESS EXPENSES. The ordinary and necessary expenses of carrying on a business conducted by a fiduciary, including a reasonable allowance for salaries, rentals, repairs to business properties, etc., have been held to be properly deductible, since they are expenses which reduce the income accruing to the beneficiaries.[40] A distinction has been made between expenses properly chargeable against the corpus of an estate at the time of its creation, and expenses incident to administration arising from the nature of the properties of an estate and the details of its business management. Thus, court costs, attorneys' fees, execu-

[37] Reg. 45, Art. 81.
[38] Revenue Act of 1918, § 219 (b); Reg. 45, Art. 341.
[39] Revenue Act of 1918, § 219 (b); Reg. 45, Art. 341.
[40] Revenue Act of 1918, § 219 (b) and 214 (a) 1.

tors' commissions, etc., have been held generally to be expenses that reduce the corpus of the estate in the fiduciary's hands and not expenses which directly reduce the income accruing to the beneficiaries. For this reason such expenses are ordinarily not a proper deduction.[41]

EXECUTORS' COMMISSIONS. If under the laws of the state, the terms of the will appointing an executor, or the decree of a court having jurisdiction of an estate, executors' commissions are deductible from the corpus of the estate, they should not be deducted by the fiduciary, but if they are to be deducted from the income of the estate distributable among the beneficiaries they may be deducted as a legitimate and necessary expense.[42]

STATUTORY ALLOWANCE TO WIDOW. A statutory allowance paid a widow out of the corpus of an estate is not deductible from gross income.[43]

TAXES. Any tax paid by a trust estate is a proper deduction to the same extent as in the case of individuals or corporations. Inheritance taxes are held not to be deductible.[44] But interest paid with respect to deferred payments of such taxes is deductible.

LOSSES. Losses sustained during the taxable year, and not compensated for by insurance or otherwise, (a) if incurred in trade or business, (b) if incurred in any transaction entered into for profit, though not connected with the trade or business, or (c) if of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, and from theft, or losses in inventory or from rebates and net losses may be deducted by fiduciaries under the rules applicable to individuals.[45] In case an estate was created prior to March 1, 1913, a loss sustained by the sale of its property is determined by the fair market price or value thereof as of that date. In case an estate was created subsequently to March 1, 1913, the loss is determined on the basis of the appraised value of the property at the time the

[41] Reg. 45, Art. 293; T. D. 2090, T. D. 2135.

[42] Letter from Treasury Department dated March 2, 1915; I. T. S. 1919, ¶ 1255.

[43] Reg. 45, Art. 341.

[44] See Chapter 25.

[45] See Chapter 25.

decedent died or the estate was otherwise created.[46] Net loss resulting from the sale of stocks, bonds, or other property owned by a trust, which would be an allowable deduction from the gross income of an individual is an allowable deduction from the gross income of a trust whether or not the income of such trust is "to be distributed to the beneficiaries periodically, whether or not at regular intervals," and whether or not there is any requirement in the instrument creating the trust, a decree of court, or a general law, that the principal of the trust shall be kept intact at the expense of income as against such loss. Such a deduction is not allowable as against the current or future gross income of the present beneficiaries, or of those who will receive the property at the termination of the trust. The beneficiary is not required to include in his personal return as a part of "his distributive share whether distributed or not, in the net income of the * * * trust for the taxable year" any part of the amounts allowed to the trust as a whole as a deduction for loss resulting from the sale of the property.[47]

DEPRECIATION. An individual who receives income from a trust estate is not permitted to claim a deduction in his personal income tax return for any depreciation sustained during the year on real estate or other assets of the estate. It is permissible, however, for the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a proper amount for the depreciation sustained during the taxable year whether or not the terms of the will or agreement creating same or a decree of court provides for the taking care of depreciation which may be sustained on the property held in trust.[48]

Net Income of Estates or Trusts. The gross income minus the deductions permitted to an estate or trust, as enumerated above, constitutes its net income. If such net income is (1) received by estates of deceased persons during the period of administration or settlement and not properly paid or credited to any legatee, heir, or other beneficiary during that period, (2) accumulated in

[46] See Telegram from Treasury Department dated February 3, 1917; I. T. S. 1919, ¶ 1183.

[47] Letter from Treasury Department dated October 13, 1919; I. T. S. 1919, ¶ 3626.

[48] Letter to Treasury Department dated October 6, 1919; I. T. S. 1919, ¶ 3632.

trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or (3) held for future distribution under the terms of the will or trust, it is to be treated as taxable income of the estate or trust on which the fiduciary must pay the tax from the funds of the estate or trust.[49] When the income upon which the fiduciary has so paid the tax is later distributed among the beneficiaries, it is a distribution of capital and no tax is at that time required to be paid by the beneficiary with respect thereto.[50] If, on the other hand, the net income is (4) to be distributed to the beneficiaries periodically, whether or not at regular intervals, or (5) is collected by the guardian of an infant, to be held or distributed as the court may direct, or (6) is properly paid or credited to any legatee, heir, or other beneficiary during the period of administration of an estate, the amount of the distributable share of each beneficiary is assessed to the beneficiary.[51] In such cases the fiduciary may be responsible for the payment of the tax, as, for instance, when the beneficiary is a minor or a non-resident alien, but the tax is still the tax of the beneficiary, and the fiduciary, in paying such tax, does not act for the estate or trust.

Credits to Trust or Beneficiary. In the case of an estate or trust taxed to the fiduciary it is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. In the case of an estate or trust taxed to the beneficiaries each beneficiary is allowed for the purpose of the normal tax, in addition to his individual credits, his proportionate share of such dividends from domestic and resident foreign corporations and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income.[52]

Credit of Tax Paid at the Source. If the trust estate is the owner of bonds on the interest of which the debtor corporation has agreed to pay any tax withheld at the source, the law requires

[49] Revenue Act of 1918, § 219.
[50] Reg. 45, Art. 344; Reg. 33 Rev., Art. 29.
[51] Revenue Act of 1918, § 219.
[52] Revenue Act of 1918, § 219 (d); Reg. 45, Art. 346.

the debtor corporation to pay for the bondholder an amount equal to 2% of the interest paid during the year. This amount is a credit against the tax to be paid on the income of the estate or trust, and should be divided proportionately among the beneficiaries and the estate according to the respective shares of the income to which each is entitled.

CREDIT FOR TAXES. The estate may be in a position to claim credit for taxes paid in foreign countries or possessions of the United States on income derived from sources in such foreign countries or possessions,[53] in which case the amount of such taxes is divided between the beneficiaries and the estate according to their respective shares of the income.

Distribution of Income of Trust Estates. The Revenue Act of 1918 provides that the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary upon income (1) received by estates of deceased persons during the period of administration or settlement and not paid or credited to any legatee, heir or other beneficiary during that period, (2) accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and (3) held for future distribution under the terms of a will or trust.[54] It provides also that the tax shall not be paid by the fiduciary upon income (4) to be distributed to the beneficiaries periodically, whether or not at regular intervals, (5) collected by a guardian of an infant to be held or distributed as the court may direct, and (6) properly paid or credited to any legatee, heir or other beneficiary during the period of administration or settlement of an estate.[55] For purposes of convenience income included in (1), (2), and (3) above are referred to hereinafter as "undistributed income," and the income referred to in (4), (5), and (6) above will be referred to as "distributable income" in the following discussion. The object of the law is to tax (1) the respective beneficiaries upon any income of estates or trusts which can be definitely and legally assigned to them during the year, and (2) to tax the estate or trust as an entity upon all income which cannot be definitely and legally assigned to some beneficiary. In

53 See Revenue Act of 1918, § 222 (a).
54 Revenue Act of 1918, § 219 (c).
55 Revenue Act of 1918, § 219 (d); Reg. 45, Arts. 342 and 345.

other words, beneficiaries are taxed when their distributive shares can be definitely determined, and if their distributive shares cannot be definitely determined at the close of the year, the tax is imposed upon the estate itself.[56]

Distributable Income. In the case of "distributable" income the fiduciary is required to report[57] the respective amounts paid or credited to each beneficiary. In such case there is included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the trust estate, for the taxable year, or if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the trust estate is computed, then his distributive share of the net income of the trust estate for any accounting period of such trust estate ending within the fiscal or calendar year, upon the basis of which such beneficiary's net income is computed.[58] The beneficiaries are required to report "distributable income" in their personal returns and to add the same to any income they may have received from other sources in order to determine their respective tax liabilities. They are entitled to their proportionate shares of the credits for purposes of the normal tax as indicated in the preceding paragraphs. The regulations governing partnerships are generally

[56] See T. D. 2231; letter from Treasury Department dated October 19, 1915; I. T. S. 1919; ¶ 1235; Revenue Act of 1918, § 219. This distinction is illustrated by a Hawaiian case in which it was held that income tax on an annuity paid out of income derived from property held in trust is assessable against the annuitant, not the trustee; but that surplus income from property held in trust and accumulating in the hands of the trustee pursuant to the terms of the will is not taxable prior to the arrival of the time for its distribution (Wilder v. Hawaiian Trust Co., 20 Haw. 589). This surplus income is taxable against the estate as an entity under the American law.

[57] This return is made on Form No. 1041, but like the return required of partnerships, as such, it is essentially a return of information only.

[58] Revenue Act of 1918, § 219 (d). In the case of a partnership or personal service corporation having a fiscal year, the distributive shares of the partners or members for any fiscal year falling within the calendar years 1917, 1918 or 1919, as the case may be, are taxed at the rates in force in those years. (See Revenue Act of 1918, §§ 205 and 206.) But the law does not authorize beneficiaries of estates or trusts with fiscal years ending in 1918 or 1919 to similarly apportion the net income from the estate or trust. All such income is taxable at the rate in force in the calendar year in which the fiscal year ends if the beneficiary reports for the calendar year.

applicable to an estate or trust which is taxed to the beneficiaries.[59]

INCOME NOT ACTUALLY PAID TO BENEFICIARIES IN YEAR. It will be noted that in the case of so-called "distributable income" the tax is paid by the beneficiary upon his distributable share *whether or not it is actually distributed.* In other words, there may be an actual or a constructive distribution of the income of an estate. When it is credited or made available to the beneficiary, it is to be accounted for by the beneficiary as if it were actually paid over to him. Where the tax on such income constructively distributed has been paid by the beneficiary, it is not again payable when at a later date the income is actually received by him.[60]

DISTRIBUTION OF INCOME OF SEVERAL YEARS. Where a decedent died in 1913, leaving a will devising a part of his estate in trust to pay the income therefrom to one beneficiary during life, and other parts to be divided among other beneficiaries, and it was impracticable for the executors to complete distribution of the estate or determine the amount of net income until 1916, at which time an account was prepared showing the net income accruing to each beneficiary during the last three months of 1913 and during the years 1914 and 1915, a large part of the accumulated income being distributed in 1916, it was held that the executors should make a fiduciary return for each of the years 1913, 1914, 1915, and 1916, reciting therein the respective beneficiaries and their interests and the beneficiaries could make amended returns for any of those years in which they would be taxable by reason of the amount so distributed.[61] In this case, apparently, the respective shares of the beneficiaries were known at all times, but the amount of net income of the estate was not determinable until 1916.

Undistributed Income. Where the tax has been paid on the "undistributed" income of an estate or trust by the fiduciary,

59 Reg. 45, Art. 345. See, however, note 58.

60 Reg. 45, Art. 345; Reg. 33 Rev., Art. 29; T. D. 2289; Reg. 33, Art. 75. The theory seems to be that such income is separated from the estate when it is credited to the beneficiary, the fiduciary thereafter holding it, not as fiduciary, but as agent for the beneficiary.

61 Letter from Treasury Department dated March 24, 1917; I. T. S. 1918, ¶ 728.

such income is free from tax when it is actually distributed to the beneficiaries.[62] Where under the terms of the will or deed the trustee may in his discretion distribute the income or accumulate it, the income is taxed to the trustee, irrespective of the exercise of his discretion. The imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from tax.[63]

Receiver in Partition Proceedings. A receiver in partition proceedings was required under the 1916 Law to report at the close of each year during the pendency of the partition suit, the net income collected from the property during such year, and pay the tax thereon.[64] Where an executor under a will is also receiver

[62] Revenue Act of 1918, § 219 (a) and (c). See also Reg. 45, Art. 344. The 1913 Law was silent as to the taxability of "undistributed" income. It was first held by the Treasury Department that if income was added to the corpus of the estate, under the provisions of the will or under a statute, no tax would accrue with respect thereto, but it was later held under that law that such income was taxable, on the theory that an estate could not be without a beneficiary for income tax purposes. Where the beneficiaries and their beneficial interest were known, the income was to be reported as accruing to them, and the estate itself was to be listed as a beneficiary with respect to any of its income not otherwise beneficially assigned or accounted for. (T. D. 2231.) The executor or administrator of an estate was required to make no return of the income until the settlement of the estate had reached the stage where the beneficiaries and their respective interests in the income were determinable, at which time returns should be made showing the annual accrual, a separate return being required for each tax year involved. (Letter from Treasury Department dated March 4, 1916; I. T. S. 1917, ¶ 576; T. D. 2289; T. D. 2231 and T. D. 1943.) The 1916 Law provided that "income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates. * * *" (Sec. 2 (b).) It has been indicated by the Treasury Department that under the 1916 Law the income received by an estate of a decedent during the period of administration or settlement was intended to be taxed as an entity whether or not any amounts were paid over to legatees, heirs, or other beneficiaries during that period, but the language of § 2 (b) of the 1916 Law seems to indicate that the law intended the tax to be imposed on the estate "except where the income is returned for the purpose of the tax by the beneficiary," and the construction generally placed upon the provisions of the 1917 Law was that the executor or administrator became liable for the tax only on the amount not paid over to a legatee or heir during the year. This point is settled by the present law.

[63] Reg. 45, Art. 342.

[64] Letter from Treasury Department dated March 14, 1917; I. T. S. 1918, ¶ 1004.

in partition proceedings the income accruing to him as receiver should be reported separately and not added to the income received by him as executor, if the receivership is separate and apart from the administration and settlement of the estate.

Returns by Fiduciaries. A fiduciary is responsible for making a return for the estate or trust for which he acts.[65] The return is required to state specifically the items of gross income received and the deductions and credits allowed against such gross income, the net income, and the respective amounts distributed to the respective beneficiaries or retained by the estate as undistributed income.[66] The return is prepared in the manner indicated on the form supplied by the Government. No special rules are applicable to fiduciaries, except that in case of income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and in the case of income collected by a guardian of an infant to be held or distributed as the court may direct, the fiduciary is required to include in his return a statement of each beneficiary's distributive share of the net income of the estate or trust, whether or not distributed before the close of the taxable year for which the return is made.[67]

BY WHOM FILED. The return is filed by the fiduciary having charge of the trust estate. Fiduciaries required to make returns are subject to all the provisions of the law which apply to individuals. Under such regulations as the Commissioner, with the approval of the Secretary, may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides, is a sufficient compliance with the requirements of the law.[68]

WHEN A RETURN IS REQUIRED. Every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) or at least one of joint fiduciaries, must make a return of income (a) for the individual whose income is in his charge, if the net income of such individual is $2,000 or over, if married and living with husband or wife, or is $1,000 or over in other cases, or (b) for the estate or trust for which he acts, if the net income of such estate or trust is $1,000 or

65 Revenue Act of 1918, § 219 (b).
66 Revenue Act of 1918, § 225.
67 Revenue Act of 1918, § 219 (b).
68 Revenue Act of 1918, § 225.

over or if any beneficiary of such estate or trust is a non-resident alien.[69]

FIDUCIARIES ACTING IN MORE THAN ONE ESTATE. In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and are in charge of the same trustee, the trustee is required to make a single return on form 1041 (revised) for all such trusts, notwithstanding that they may arise from different instruments. When, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he is required to make a return on form 1041 (revised) for each trust separately.[70]

WHERE FILED. The return of a fiduciary should be filed in the collection district in which the fiduciary resides or has his place of business, regardless of the residence of the beneficiaries.[71] Where an estate has two or more joint fiduciaries, the return may be filed by one of them in the district where he resides, such filing being a sufficient compliance with the law.[72]

WHEN FILED. The return must be filed on or before March 15th in each year or on or before the fifteenth day of the third month following the close of the fiscal year of the estate or trust. accordingly as it reports upon the basis of the calendar or a fiscal year.[73]

EXTENSION OF TIME. The same extension of time may be granted for filing the returns of fiduciaries as may be granted to individuals.

HOW SIGNED AND SWORN TO. The law provides that the fiduciary shall make oath that he has sufficient knowledge of the affairs of the individual, trust, or estate for which he acts, to enable him to make the return and that the same is, to the best of his knowledge and belief, true and correct.[74] When the return is signed and sworn to by an individual as a fiduciary his full

69 Revenue Act of 1918, § 225; Reg. 45, Art. 421. The return in case (a) and also in case (b) if the tax is payable by the fiduciary should be made on Form 1040 (revised), except that it may be on short Form 1040-A (revised) where the net income does not exceed $5,000. The return may be made on Form 1041 (revised) in case (b) if the tax is payable by the beneficiaries.

70 Reg. 45, Art. 423; T. D. 2090, T. D. 2137.

71 Revenue Act of 1918, § 227 (b).

72 Revenue Act of 1918, § 225.

73 See Chapter 34.

74 Revenue Act of 1918, § 225.

address is required to be stated. If the fiduciary is an organization, the return is signed and sworn to by the president, secretary or treasurer.[75]

Returns for Beneficiaries. As a general rule, the fiduciary is not required to make any return of "distributable" income, as that term is defined in a previous paragraph,[76] for and on behalf of his beneficiary. If, however, the fiduciary has been legally authorized to act as agent for the beneficiary, or is an attorney-in-fact for him, he may also make and file the personal return of the beneficiary in the same manner as any other duly authorized agent.[77] If the beneficiary is unable to make his own return, or is a non-resident alien, the fiduciary is required to make the personal return for him, as indicated in the following paragraphs.

For Minors or Insane Persons. A fiduciary acting as the guardian of a minor having a net income of $1,000 or $2,000, according to the marital status of such person, must make a return for such minor and pay the tax, unless such minor himself makes a return or causes it to be made. A fiduciary acting as the committee of an insane person having an income of $1,000 or $2,000, according to the marital status of such person, must make a return for such incompetent and pay the tax.[78]

For Non-Resident Alien Beneficiaries. Where a citizen or resident fiduciary has the distribution of trust income for which there is a non-resident alien beneficiary, the fiduciary must make a return for such non-resident alien and pay the tax. If there are two or more beneficiaries, the fiduciary should render a return on form 1041 (revised) and also a return for each non-resident alien beneficiary.[79]

Income to Be Reported by Beneficiary. Unless the beneficiary is under some disability which requires a fiduciary to act, the beneficiary makes his own personal return and accounts for the tax upon his entire net income, including that which has been received from the estate.[80] The fiduciary is not under any duty

75 Reg. 33, Art. 73. See Instructions on Form 1041.

76 See p. 83.

77 See Reg. 33, Art. 72.

78 Reg. 45, Art. 422. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose.

79 Reg. 45, Art. 425. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose.

80 See T. D. 2090. See p. 83.

to account for or pay the tax on amounts distributed to beneficiaries where the beneficiary is capable of making his own return and is not a non-resident alien. The beneficiary reports the income for the year in which it is received by him or credited to him,—that is, for the year in which it is actually or constructively received. All amounts paid by fiduciaries to beneficiaries of trust estates from the income of such trust estates, whether from reserves or otherwise, are held to be distributions of income and will be treated for income tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries. The beneficiary will be required in the case of trust estates to account for the actual amounts distributed or credited to him.[81]

Returns of Executors and Administrators. In addition to the duties which executors and administrators have in common with other fiduciaries, they are also required to report the income of the decedent for that part of the last taxable year during which he lived; and also for the preceding taxable year, if the decedent died before the time for filing returns for such year had expired and no return had been filed by him. Thus, if a decedent died in February, 1920, without having made a return for 1919 the executor or administrator is required to file a return for 1919 and a return for the part of 1920 in which the decedent lived.[82] If the net income of the decedent, from January 1 of the year in which he died to the date of his death, was less than the sum which would have made him liable to make a return if living, no return is required by the executor or administrator.[83] The personal exemption which may be deducted from the decedent's income so reported is the full amount allowed to living persons of

81 Reg. 33 Rev., Art. 29. See Revenue Act of 1918, § 219.

82 Revenue Act of 1918, § 223. Returns seem to be required of executors or administrators in such cases on the theory that by reason of death the decedent is unable to make his own return, a return therefore being required by the "person charged with the care of the person or property of such taxpayer." See Brady v. Anderson, 240 Fed. 665, writ of certiorari denied 244 U. S. 654; Mandell v. Pierce, 3 Cliff. 134, 16 Fed. Cas. No. 9008; Reg. 33 Rev., Arts. 4 and 14.

83 Revenue Act of 1918, § 223; Reg. 45, Art. 421. See also T. D. 2090 and Reg. 33, Art. 17.

the same status as that of the decedent at the time of his death, or at the end of the last taxable year he lived.[84]

TIME FOR FILING RETURN UPON DEATH OR TERMINATION OF TRUST. As soon as possible after his appointment and qualification, without waiting for the close of the taxable year, an executor or administrator should file a return of income for the decedent. Upon the completion of the administration of an estate and final accounting an executor or administrator should file a return of income of the estate for the portion of the taxable year in which the administration was closed, attaching to the return a certified copy of the order for his discharge. An ancillary administrator need make no separate return if the domiciliary administrator includes in his return the entire income of the estate. Similarly, upon the termination of any other trust the trustee should make a return without waiting for the close of the taxable year. In any such case the requirements with respect to the payment of the tax are the same as if the return were for a full taxable year closing at the end of the month during which the decedent dies or the estate is settled or the trust is terminated, as the case may be. The payment of the tax before the end of the taxable year in such circumstances does not relieve the taxpayer from liability for any additional tax which might subsequently be imposed upon income of the taxable year.[85]

LIABILITY OF EXECUTORS FOR TAX. Liability for payment of the income tax attaches to the person of an executor or administrator up to and after his discharge, where prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in determining whether or not such obligations existed. Liability also follows the estate itself, and when, by reason of the distribution of the estate and the discharge of the executor or administrator, it appears that the collection of the tax cannot be made from the executor or administrator, the legatees or distributees must account for their proportionate share of the tax due and unpaid. The same considerations apply to other trusts.[86]

Withholding at the Source Against Fiduciaries. The provisions with respect to withholding the tax at the source apply in

[84] Reg. 33 Rev., Art. 14. See Chapter 31.
[85] Reg. 45, Art. 442; Reg. 33 Rev., Art. 26.
[86] Reg. 45, Art. 344; Reg. 33 Rev., Art. 29.

the case of payments to fiduciaries in the same manner as in the case of payments to individuals. There is, generally speaking, no withholding at the source on payments to citizens and residents of this country and, it follows that there is no withholding at the source in the case of a fiduciary who is a citizen or a resident, or has an office or place of business in this country. The one exception to this rule is the withholding of a tax equal to 2% on interest paid on obligations of corporations containing a tax-exempt covenant. In such cases the tax is in theory withheld, but not in actual fact, since the paying corporation assumes the burden of the tax, paying the interest in full to its bondholder. Although the fiduciary may be a corporation, in its capacity as fiduciary it is subject to the provisions of law applicable to individuals and not to corporations; hence on payments of such interest as that referred to in the preceding sentence, the paying corporation will be required to treat the corporation fiduciary as an individual and assume the burden of the 2% tax.[87]

Withholding at the Source by Fiduciaries. A fiduciary is expressly required to withhold the tax at the source in the same cases in which individuals, corporations and partnerships are required so to do; that is, the tax must be withheld at the source by a fiduciary upon all annual or periodical payments of fixed and determinable income to non-resident aliens and non-resident foreign corporations.[88]

Information at the Source. Fiduciaries are expressly subject to all the provisions of the law requiring information at the source. These requirements are discussed in full in a subsequent chapter.[89]

Penalties. The Revenue Act of 1918 provides that fiduciaries required to make returns shall be subject to all the provisions which apply to individuals.[90] Fiduciaries are liable to the same penalties, so far as they are applicable, as those which may attach to individuals. These penalties are discussed at length in another chapter.[91]

87 See Chapter 40.
88 See Chapter 40.
89 See Chapter 39.
90 Revenue Act of 1918, § 225.
91 See Chapter 36.

Foreign Fiduciaries. The term "foreign fiduciary" as here used means a fiduciary who neither resides in this country nor has an office or place of business here, that is, one who is not within the jurisdiction of this government. The Revenue Act of 1918 provides that "fiduciaries required to make returns under this Act shall be subject to all the provisions of this Act which apply to individuals."[92] The law implies that foreign fiduciaries shall be subject to its provisions to the same extent as non-resident alien individuals.

TRUST ESTATES. The trust estate under the control of a foreign fiduciary is subject to tax on net income derived from sources within this country. Net income from sources within this country is determined under the same rules as apply to non-resident aliens.[93] The deductions claimed by the foreign fiduciary are governed by the rules relating to fiduciaries in general, except so far as they are limited by rules relating to the deductions allowed to non-resident aliens. The same rules applicable to domestic fiduciaries with respect to "distributed" and "undistributed" income apply to foreign fiduciaries.

RETURNS OF FOREIGN FIDUCIARIES. Under the Revenue Act of 1918, a foreign fiduciary is required to make under oath a return for the individual, estate or trust for which he acts, stating specifically the items of the gross income received from sources within this country, and the deductions and credits allowed by the law, and the respective shares distributable to beneficiaries. The fiduciary is required to make oath that he has sufficient knowledge of the affairs of the individual, estate or trust for

[92] Revenue Act of 1918, § 225.

[93] See Chapter 4. In state ex rel. Wisconsin Trust Co. v. Widule, 164 Wis. 56, it was held that dividends from stocks and interest upon notes, mortgages, etc., received by a resident trustee (individual or corporation) as a gain or profit from securities constituting the trust fund, were taxable as income from sources within Wisconsin, even though the person entitled to the enjoyment and to whom they must be paid over was a non-resident and also a co-trustee and even though two of the three trustees resided without the state. The resident trustee was held to be the recipient of the income. It has also been held in Wisconsin (Bayfield Co. v. Pishon, 162 Wis. 466, 156 N. W. 463) that where income of a non-resident testamentary trustee was derived from sources without the state, the fact that the trust was being administered by a Wisconsin court was insufficient to subject the income to tax; that it was not sufficient that "sources" be *constructively* within the state.

which he acts to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.[94] In making the return he should comply with the law and regulations respecting returns by non-resident aliens. In the case of foreign fiduciaries the law is silent, but seemingly a return will be required by the Treasury Department if the foreign fiduciary has received *any* net income from sources within the United States during the taxable year.

Where Filed. In the case of foreign fiduciaries the return should be filed with the Collector at Baltimore, Maryland.[95]

When Filed. Returns of foreign fiduciaries are filed at the same time as those of domestic fiduciaries.[96] The same general rules are applicable to the filing of returns by non-resident aliens and by foreign fiduciaries. The same extensions of time may be granted and the same penalties imposed for neglect or failure to file.[97]

Withholding at the Source Against Foreign Fiduciaries. The provisions with respect to withholding the tax at the source apply, in the case of payments to foreign fiduciaries, in the same manner as in the case of payments to non-resident aliens. A foreign fiduciary may not receive the benefit of the specific exemption by filing a claim therefor with the withholding agent,[98] and cannot otherwise claim exemption from withholding of the tax at the source.[99] He may claim the benefit of deductions and credits and obtain a refund of any amounts withheld in excess of the tax liability of the estate, in the same manner as is prescribed with respect to non-resident alien individuals.[100]

Withholding at the Source by Foreign Fiduciaries. Since a foreign fiduciary is not personally within the jurisdiction of this Government, the requirements imposed upon domestic or res-

94 Revenue Act of 1918, § 225.

95 Revenue Act of 1918, § 227 (b).

96 Revenue Act of 1918, §§ 225 and 227 (a).

97 See Chapters 34 and 36.

98 Revenue Act of 1918, § 217. This provision of the law authorizes the Commissioner to permit non-resident aliens to claim exemption at the source. but no such permission has been granted except as to alien employees. See Chapter 40.

99 Letter from Treasury Department dated December 28, 1916; I. T. S. 1919, ¶ 546.

100 See Chapter 4.

ident fiduciaries to withhold the tax in paying income to non-resident aliens do not apply to such fiduciaries.

INFORMATION AT THE SOURCE BY FOREIGN FIDUCIARIES. A foreign fiduciary is under no duty to supply the Government with information at the source as to payments made to others, except so far as information is supplied with respect to beneficiaries in the return of income.

CHAPTER 7

FARMERS

The application of the income tax law in the case of farmers presents certain peculiar difficulties and has been the subject of particular consideration on the part of the Treasury Department. A number of rulings and regulations relating specifically to farms and farming have resulted.[1] These rules pertain mainly to special items of a farmer's income, the methods permitted for the computation of his gross income, and the application of the statutory deductions to the transactions usually involved in the business of farming.

Definition. The term "farming" is defined as embracing the farm in the ordinarily accepted sense and includes stock farms, dairy farms, poultry farms, fruit farms, truck farms, plantations, ranches, and all land used for farming operations; and the term "farmer" is defined as all corporations, partnerships or individuals who cultivate, operate, or manage such farms for gain or profit, either as owners or tenants.[2]

"Gentlemen Farmers." A person cultivating or operating a farm for recreation or pleasure, and not upon the basis of the recognized principles of commercial farming, the usual result of which is a loss from year to year, is not regarded as a farmer. In such cases, if the operation of a farm results in a net gain for the year, such gain must be reported as income. If, however, the expenses and losses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income; and the expenses, being regarded as personal expenses, will not be allowed as a deduction from the income derived from other sources.[3]

[1] Reg. 45, Arts. 38, 110, 145, 171; T. D. 2665, amending T. D. 2153; Reg. 33 Rev, Arts. 4 and 123.

[2] Reg. 45, Art. 35; T. D. 2665.

[3] Reg. 45, Arts. 35 and 110; Reg. 33 Rev., Art. 4. If a farmer buys a

Farmers Keeping Books and Taking Inventories. Farmers keeping books according to approved methods of accounting, and whose books clearly reflect net income, and taking annual inventories may, if the same method is consistently followed from year to year, prepare their returns in accordance with the showing made by their books and inventories.[4]

Inventories. If the inventory method is adopted, the farmer should, in order to ascertain gross income, add to the amount received from sales made during the year, the inventory of the live stock and products on hand at the close of the year and from this sum deduct the amount expended in purchasing live stock and products plus the inventory of the live stock and products on hand at the beginning of the year. The inventory at the beginning of the year must correspond with the inventory at the close of next preceding year and it (a) *must* include the cost of live stock or products purchased for resale, (b) *may* include live stock and products produced on the farm still on hand.[5] If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year.[6] Live stock purchased for draft, breeding, or dairy purposes, or for

farm which is much run down, with the intention of making it a profit paying property, to do which he is obliged to expend large amounts for labor in plowing and cultivating the land, for fertilizer, lime, etc., so that for several years the expenses will greatly exceed the gross receipts, the excess of such expenses over such receipts may be claimed as a loss against other income, provided the farm continues to be operated on a strictly commercial basis. (Income Tax Primer for Farmers, Question 80.)

4 Reg. 45, Art. 35; T. D. 2665. See Chapter 16.

5 T. D. 2665. Income Tax Primer for Farmers, Questions 95-100. An example of the inventory method is as follows:

Sales of live stock and products during year	$9,000	
Inventory of live stock and products at close of year	4,000	
		$13,000
Inventory of live stock and products at beginning of year	3,000	
Cost of live stock during the year	2,000	5,000
Gross income from farming		$8,000

6 Reg. 45, Art. 145.

any purpose other than resale, may be included in the inventory for each year at a figure which will reflect the reduction in value estimated to have occurred during the year through increase of age or other causes. Such a reduction in value should be based on the cost and estimated life of the live stock.[7] In the case of loss of such live stock no deduction can be made, as the loss will be reflected in the inventory at the close of the year. When an inventory is used, the cost price of the article sold must not be taken as an additional deduction in the farmer's return of income, as such cost price is reflected in the inventory.[8]

Accounting on an Accrual Basis. Farmers keeping books are required to report their income on the cash or accrual basis, according to the method of accounting employed by them in keeping their books.[9]

Farmers Not Keeping Books and Not Taking Inventories. All farmers not keeping books and not taking inventories must report on the basis of actual receipts and disbursements, in order that their returns may permit of audit for the purpose of verification.[10]

Income. The income of a farmer may be in cash or in kind; that is, like the income of any other individual or corporation subject to tax, it may consist of money or of a money equivalent. In general, the income of a farmer may be said to be determined according to the same principles which determine the income of other taxable individuals or corporations, but certain special rules are set forth in the following paragraphs.

VALUE OF PRODUCTS CONSUMED BY FARMER. A farmer is not required to report as income the value of farm products consumed by himself and family.[11]

7 Reg. 45, Art. 171.

8 Reg. 45, Art. 38.

9 Revenue Act of 1918, § 212; T. D. 2665; T. D. 2433. This subject is discussed in Chapter 33.

10 T. D. 2665. See Chapter 33.

11 Under this rule a farmer may use 100 bushels of potatoes for himself and family without being subject to tax, but if he should sell the potatoes, and use the proceeds in buying other potatoes for his family, he would be taxable. The rule seems incongruous, but may be the only practicable one under the circumstances. Speaking of a somewhat similar provision of the Hawaiian law the Court said in Robertson v. Pratt, 13 Haw. 590: "* * * tax laws must be

INCOME FROM RENTS RECEIVED IN KIND. Rents received in crop shares are to be reported as income for the year in which the crop shares are sold or otherwise reduced to money or a money equivalent.[12]

INCOME FROM SALE OR EXCHANGE OF ANNUAL PRODUCE. All gains, profits and income derived from the sale of annual produce, whether produced on the farm or purchased and resold by the farmer, must be reported as income for the year in which the product is actually marketed and sold, unless an inventory is used.[13] Where a farmer exchanges farm produce for merchandise, groceries, or mill products, the market value of the article or property received should be reported as income.[14]

INCOME FROM SALE OF LIVE STOCK. For the purpose of this discussion, live stock may be divided into three classes: (1) live stock raised on the farm, (2) live stock purchased by the farmer for the purpose of resale at a later time, and (3) live stock raised or purchased for draft, breeding or dairy purposes, or any purpose other than resale. Where a farmer keeps books and carries the value of his live stock in annual inventories, the total amount received on the sale of any such stock should be entered on his books as gross receipts, and the income therefrom will be reflected through the inventories.[15] Where the farmer does not keep books and take inventories, the profit or income from the sale of live stock is, generally speaking, the difference between the cost thereof and the amount received on the sale.[16] This general rule is, however, subject to several qualifications or exceptions, as follows:

practical. It would be next to impossible for everyone to keep an account and estimate the value of everything he produced and consumed."

12 Reg. 45, Art. 38, Reg. 33 Rev., Art. 4.

13 Reg. 45, Art. 38; T. D. 2665. The sale of crops, dairy products, eggs and fruit, falls within this rule. (See Income Tax Primer for Farmers, Question 30.)

14 Reg. 45, Art. 38; T. D. 2665. The rulings do not cover cases where farm products are exchanged or bartered for other articles or property having no definitely ascertainable market value, as for instance, the exchange of one horse for another, and it would seem no taxable income accrues to either party in such transaction. See Chapter 14.

15 T. D. 2665. The rulings permit, but do not require the value of live stock raised on the farm to be carried in inventory.

16 Reg. 45, Art. 38. Of course, if the selling price is less than the cost the result will be a loss.

(a) When the live stock was owned on March 1, 1913. If the live stock was owned by the farmer on March 1, 1913, whether raised on the farm or purchased, the fair market price or value on that date should be deducted from the selling price; and the cost, if any, disregarded.[17]

(b) When the live stock was raised on the farm. If the live stock was raised on the farm, the farmer has no purchase price to deduct and the entire selling price is income, unless the live stock was owned on March 1, 1913, in which case the rule stated in the preceding paragraph will apply. The cost of raising such stock is not deducted from the selling price, since such cost is an item of annual expense, which should be deducted from year to year, as incurred.

(c) When the live stock has been purchased. When the live stock has been purchased, the purchase price thereof should be deducted from the selling price, unless the stock was acquired before March 1, 1913, in which case the rule stated in paragraph (a) above will apply. The expense of care, feeding and marketing such stock is not deducted from the selling price, but is treated as an item of annual expense.[18] A special rule may apply in the cases referred to in this paragraph. Under a former regulation of the Treasury Department[19] a farmer was permitted to charge to expense the cost of live stock purchased for resale. Where the cost of live stock has been charged to expense and claimed as a deduction under that regulation in any past year, the entire proceeds from the sale of such live stock must be returned as income for the reason that the farmer is not again entitled to the benefit of a deduction which he has already received.[20]

(d) Live stock used for draft, breeding or dairy purposes. Where live stock has been purchased or raised for draft, breeding or dairy purposes, and is sold, the income is ascertained in the manner indicated in the preceding paragraph, unless the farmer

17 See Chapter 17.

18 T. D. 2665.

19 T. D. 2153, dated February 12, 1915.

20 T. D. 2665, Income Tax Primer for Farmers, Question 30. In such cases, however, it seems the return for the year in which the stock was purchased might be amended to conform to present rulings and the return for the year in which the stock was sold prepared accordingly.

has claimed a deduction for the depreciation of such stock in any year.[21] In such cases the aggregate amount allowed for depreciation in preceding years must be added to the selling price in order to ascertain the taxable profit.[22] Thus, if $35 has been claimed for depreciation in each of three years on a horse purchased for $500 and sold for $550, the taxable profit will be ascertained by adding the depreciation for three years, amounting to $105, to the selling price, making a total of $655, and subtracting from such total the purchase price of $500, leaving a taxable profit of $155.

INCOME FROM SALE OF OTHER FARM PROPERTY. Income from the sale of other farm property should be reported in accordance with the general rules set forth in another chapter.[23]

DIVIDENDS FROM COOPERATIVE ASSOCIATIONS. All dividends from cooperative associations must be included in a farmer's gross income. They are not exempt from the normal tax for the reason that the association itself is not taxed upon its earnings. They simply represent additional amounts accruing to the farmer upon sales through the association. Dividends from cooperative *buying* associations are to be treated in the same manner as dividends from cooperative *selling* associations.[24]

INCOME FROM OTHER SOURCES. If the cost of produce, live stock or other property which has been lost or destroyed is deducted as a loss and subsequently the farmer is reimbursed in whole or in part by the state or federal authorities (e. g. where the stock has been killed to avoid the spreading of disease) or by insurance or indemnity, the amount so received as reimbursement is income.[25] This contemplates a case where the loss may have been deducted in one year and the reimbursement is received in another year. It is allowable, however, and advisable that no loss be claimed in such cases until the reimbursement has been received, as until that time the net loss is not ascertainable. When the reimbursement is received, it should then be treated the same as if it represented the selling price and the

21 See p. 104, for the rules regarding Depreciation.

22 Reg. 45, Art. 38. The same rule applies when farm machinery is sold.

23 See Chapter 17.

24 Income Tax Primer for Farmers, Questions 49 and 50.

25 Reg. 33 Rev., Arts. 4 and 123.

gain or loss determined according to the rules set forth in the preceding paragraphs relative to sales. If a farmer works out his road or other taxes and claims such taxes as a deduction he must also include the same amount as income, as by the work he earns sufficient to pay the taxes. If he does not claim deduction for such taxes he need not include a corresponding amount as income. All amounts received for board of persons, board and pasturage of animals, labor men and teams, and the hire or use of machinery must be reported as income by a farmer.[36]

Computing Income Upon Crop Basis. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such case the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.[37]

Deductions. The special rules in regard to the deductions permitted to farmers are set forth in the following paragraphs. In the case of statutory deductions not treated below the general rules relative to all taxpayers apply.

Expense. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools, of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included. The purchase of a cultivator and mowing machine constitute improvements. They have an estimated life of more than one year and payment for them should be considered a capital expenditure. A reasonable amount of depreciation of the machines may be deducted from gross income. The same principles apply to the purchase of a threshing machine. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process

[36] Income Tax Primer for Farmers, Question 28. These items are reported under the head of "Income From Business or Profession" on the Tax Return.

[37] Reg. 45, Art. 38.

of gathering and disposal, expenses deducted may be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. The amount expended in purchasing draft or work animals or live stock either for resale or for breeding purposes is regarded as an investment of capital. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs and upkeep of an automobile if used wholly in the business of farming is deductible as an expense, if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense.[28] Any payments which a farmer is compelled to make as a result of a collision between his automobile and a vehicle is an allowable deduction if the automobile was being used in connection with his business at the time of the

[28] Rev. 45, Art. 110; Income Tax Primer for Farmers, Questions 59 and 72. Under Reg. 33 Rev., Art. 4 and T. D. 2153, dated February 12, 1915, the deduction of expenses in the return *for the year* in which they were made, even though the crops and stock in connection with which they were incurred may not have been marketed during the year for which the return was rendered, was only permissible. Where under the former rulings a farmer had not deducted the cost of producing the farm products he might deduct the same from the selling price and report only the difference as income. T. D. 2665 limited such deduction to the year in which the expenditures were made. The above ruling in relation to crops which take more than a year from the time of planting to the process of gathering and disposal limits the deduction to the year in which the gross income from the crop is realized. It was formerly held that the cost of stock purchased for resale might, at the option of the farmer, be deducted as an expense, or taken into consideration upon the sale of such stock, but that money expended for stock for breeding purposes was, as now, to be regarded as capital invested and therefore not deductible, except as the stock depreciated in value. (See also Reg. 33 Rev., Arts. 4 and 123.)

collision. The rule is otherwise if he was riding for pleasure.[29] The cost of digging irrigation ditches is not an allowable deduction but the cost of repairing such ditches may be deducted.

SALARIES. Amounts paid to a male employee assisting a farmer in operating the farm are an allowable deduction. A line must be drawn as to compensation paid to a female employee who assists a farmer about the house. If her time is employed entirely in taking care of milk and cream produced for sale, in the production of butter, cheese, etc., the care of milk cans and churns, or, if a separate table is maintained for laborers employed on the farm and her services are used entirely in the preparation and serving of the meals furnished the laborers and in caring for their rooms, the compensation paid her constitutes an allowable deduction. If, however, she is employed to assist in caring for the farmer's own household, no deduction can be claimed. Salaries paid to minor children may not be claimed as a deduction.[30]

IRRIGATION COMPANY ASSESSMENTS. In California and other states, fruit growers, ranchers and farmers are shareholders in irrigation companies, which are mutual in character, and they are often assessed, in proportion to their holdings of stock, for sufficient amounts to make repairs to the irrigation system, cleaning out pipes, laterals, etc. Such assessments can be claimed as a deduction under the heading of business expenses where their purpose is merely to raise funds to keep the irrigation system in usable condition, and not to make extensions and betterments.[31]

TAXES. In general, the rules respecting the deduction of taxes by farmers are the same as the rules respecting the deducting of taxes by other individuals or corporations subject to tax, and are discussed elsewhere in this book.[32] Farmers who work out road or other taxes may deduct the amount thereof, but if they do so they must also report the same amount as income.

LOSSES. Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products

[29] Income Tax Primer for Farmers, Questions 71 and 73.

[30] Income Tax Primer for Farmers, Questions 66 and 67.

[31] Income Tax Primer for Farmers, Question 70.

[32] See Chapter 24.

are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage will be allowed. The total loss by frost, storm, flood or fire of a prospective crop, or of a crop which has not been sold, is not a deductible loss in computing net income.[33] A farmer engaged in raising and selling stock, cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm. If live stock has been purchased for any purpose, and afterwards dies from disease, exposure or injury, or is killed by order of the authorities of a State of the United States, the actual purchase price of such stock, less any depreciation which may have been previously claimed with respect to such perished live stock, less also any insurance or indemnity recovered, may be deducted as a loss. The actual cost of other property, less depreciation already allowed, destroyed by order of the authorities of a State or of the United States may in like manner be claimed as a loss; but if reimbursement is made by a State or the United States, in whole or in part, on account of stock killed or property destroyed, the amount received must be reported as income for the year in which reimbursement is made. In determining the cost of stock for the purpose of ascertaining the deductible loss there shall be taken into account only the purchase price, and not the cost of any feed, pasturage, or care which has been deducted as an expense of operation. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure.[34]

DEPRECIATION. A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property, including live stock purchased for draft, dairy, or breeding purposes, but no claim for depreciation on live stock raised or purchased for resale will be allowed. If an inventory is not used,

[33] The value of such a crop has never entered into gross income, and the cost of raising the same is deductible as a necessary expense. (Income Tax Primer for Farmers, Question 78.)

[34] Reg. 45, Art. 145; Reg. 33 Rev., Arts. 4 and 123; T. D. 2665.

a reasonable allowance for depreciation may be claimed, based upon the cost of draft and work animals and animals kept solely for breeding purposes and not for resale.[35]

Returns of Farmers. Farmers are required to make returns of annual income or special returns with respect to withholding at the source, information at the source, and other matters in the same manner and according to the same rules as those prevailing in the case of all individuals and corporations. This subject is treated elsewhere in this book.[36] In addition to the annual return of income, farmers are required to prepare and file a "schedule of farm income and expenses" (Form 1040 F) copies of which may be obtained from the local collector.

Payment of Tax; Penalties. Farmers pay the tax in the same manner as other individuals and corporations.[37] They are also subject to all the penalties which may be imposed upon other individuals and corporations.[38]

[35] Reg. 45, Art. 171; Reg. 33 Rev., Arts. 4 and 123. For the rule when an inventory is used, see p. 96.

[36] See Chapter 34.

[37] See Chapter 35.

[38] See Chapter 36.

CHAPTER 8

PARTNERSHIPS

The Revenue Act of 1918 provides[1] that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity and that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or if his net income is computed upon the basis of a period different from the basis upon which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.[2] The Revenue Act of 1918 contains a new provision requiring partnerships to file returns for each taxable year.[3]

Domestic and Foreign Partnerships. General partnerships are divided into two classes, domestic and foreign. A domestic partnership is one organized or created in the United States, includ-

1 Revenue Act of 1918, § 218 (a). Partnerships as such were not taxable under the 1916 Law, the partners thereof being taxable in their individual capacity. (Revenue Act of 1916, § 8 (e); T. D. 1957.) Partnerships were expressly excepted from the tax on corporations. (Revenue Act of 1916, § 10.) In U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27, arising under the 1913 Law, the court said in part: "This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. * * * The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name."

2 See p. 119 as to rates of tax applicable where the fiscal year of a partnership falls in calendar year in which rates are changed.

3 See Revenue Act of 1918, § 224.

ing only the States, the Territories of Alaska and Hawaii, and the District of Columbia, and a foreign partnership is one organized or created outside the United States as so defined. The nationality or residence of members of a partnership does not affect its status. A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership.[4]

Limited Partnerships. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the mean-

[4] Reg. 45, Art. 1508. According to this definition (which is practically unavoidable in view of the definitions contained in Section 1 of the Statute), a partnership composed entirely of citizens and residents and doing all its business here would be a "foreign" partnership if created by articles entered into in a foreign country. The intention of the parties as to the place where the principal business is to be carried on (which is best evidenced by the subsequent acts of the partnership) would seem to be a sounder basis for a distinction between domestic and foreign partnerships. Thus, a domestic partnership would be one which has its principal place of business in this country and directs all or the greater part of its business from its office or offices in this country, whether or not the partners are citizens or aliens, residents or non-residents, and a foreign partnership would be one which has its principal place of business in a foreign country and directs all or the principal part of its business from its office outside the jurisdiction of the United States, whether or not the partners are citizens or aliens, residents or non-residents. This distinction would be more consistent with the recent ruling that dividends on stock and interest on obligations of corporations organized in the United States, but doing no business and owning no property therein, paid to non-resident alien individuals or corporations, are not subject to the income tax. (Reg. 45, Art. 92.)

The 1916 Law expressly mentioned foreign partnerships in only one provision (Revenue Act of 1916, § 13 (e)) that which required the withholding of the tax on payments of income from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations, to non-resident alien firms and copartnerships not engaged in business or trade within the United States and not having any office or place of business therein. No definition of the term "alien partnership" was given in the law or was to be found in the regulations. The Law also referred to "non-resident alien firms" and to "non-resident alien copartnerships" synonymously, and applied the terms without regard to whether or not the firm or copartnership was engaged in business or trade within the United States or had an office or place of business in this country. The term may be argued to have had reference to the status of the partners composing the firm, and in this respect it was indefinite, as a firm may be composed of non-resident aliens and resident aliens or citizens.

ing of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Illinois limited partnerships are held to be partnerships. A California special partnership is a partnership. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership is a corporation. Such a corporation may or may not be a personal service corporation.[5]

[5] Reg. 45, Art. 1505, Art. 1506 as amended by T. D. 2943. In Art. 1506 as first promulgated Virginia partnership associations, also, were held to be corporations. Under the 1909 Law it was held that a limited partnership was liable for the tax, if organized for profit and having a capital stock represented by shares, although no "certificates of stock" were issued. (Op. Atty. Gen. Fed. 14, 1910.) Limited partnerships were first broadly and without any qualifications held to be in the same category as corporations or associations under the 1916 Law and subject to the income tax imposed on such entities. The profits of limited partnerships so reporting were treated as dividends and were not subject to the normal tax in the hands of the partners receiving them but were subject to the additional or surtaxes in the hands of such partners. (Reg. 33 Rev., Art. 62; Reg. 33, Art. 86; T. D. 2137.) A limited partnership was defined as a form of business organization created by statute in many of the United States, wherein the liability of certain special partners, who contribute a specific amount of capital, is limited to the amount so contributed, while the general partners of the same partnership are jointly and severally responsible as in ordinary partnerships. (Reg. 33 Rev., Art. 62.) It was held that a limited partnership would be classed as a quasi-corporation or association within the meaning of the law. In a letter dated January 19, 1916, written with

Partnership Associations. Under the 1909 Law the Attorney General held that partnership associations organized under the laws of Pennsylvania (referred to in the foregoing paragraph as limited partnerships of the Pennsylvania type), possessing every privilege and power essential to a corporation were properly taxable as corporations.[6] Such associations have capital contributed by the partners, who are not individually liable beyond the unpaid capital subscribed by each. The other characteristics of such associations which are more in the nature of a corporation than of a partnership are that the word "Limited" must be a suffix to the name, the interest of a partner may be transferred and new partners may be taken in by vote of a majority of the partners, and the association may sue or be sued in the association name. Michigan and Virginia partnership associations are of this type and are held to be taxable as corporations.[7]

Dividends from Limited Partnerships. The profits of limited partnerships of the Pennsylvania type should be treated by the members of the partnership as dividends of corporations are treated by stockholders.[8] Members of limited partnerships should ascertain if the partnership is paying a tax according to this requirement and if so the normal tax should not again be paid on their shares of the profits.

Private or Partnership Banks. A partnership bank conducted like a corporation and so organized that the interests

particular reference to limited partnerships of the type created under the New York Statute, Laws of 1897, Ch. 427, § 3D, the Treasury Department gave its reasons for classifying limited partnerships with corporations. After quoting the language of Revenue Act of 1916, § 10 (a), which imposed a tax on "every corporation, joint-stock company or association, or insurance company * * * but not including partnerships" the letter stated that the term "partnership" as there used was a common law term and applied only to such partnerships as were known to the common law. The Treasury Department later modified this ruling, drawing a distinction between limited partnerships of the Pennsylvania type and New York type and holding that, for purposes of the income, excess-profits and capital stock taxes, limited partnerships of the New York type were partnerships and limited partnerships of the Pennsylvania type were corporations or joint-stock companies. (T. D. 2711; Letter from Treasury Department dated May 4, 1918; I. T. S. 1918, ¶ 3355; Telegram from Treasury Department dated April 24, 1918; I. T. S. 1918, ¶ 3325.)

6 28 Op. Atty. Gen. 189 (1910).

7 Reg. 45, Art. 1506. See note 5.

8 T. D. 2137.

of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership.[9]

JOINT OWNERSHIP AND JOINT ADVENTURE. Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners.[10]

General Partnerships. A general partnership, or what is known as a common law partnership, which Congress clearly intended to be exempt from the income tax law, is one which does not have a separate entity, but is composed of two or more individuals associated together for the purpose of carrying on a given business or transaction. Such a partnership has been defined by the courts as "a business organization in which every partner possesses full power and absolute authority to bind all the partners by his acts or contracts in relation to the business of the firm, in the same manner and to the same extent as if he held full power of attorney from them."[11] Among the principal

9 Reg. 45, Art. 1503; T. D. 2137.

10 Reg. 45, Art. 1507.

11 Letter from Treasury Department dated January 19, 1916. This letter held all limited partnerships to be corporations for income tax purposes, as stated above. (See note 5.) The definition given is known as the test of mutual agency and has been criticised, as being neither strictly logical nor entirely satisfactory, on the ground that agency results from the partnership and not the partnership from the agency and on the ground that the existence of a relation of mutual agency is the very question at issue. (See Boreing v. Wilson, 33 Ky. L. 14, 108 S. W. 914.) There is great conflict of authority in the American decisions on the subject. The so-called "intention" test is usually applied as between the partners while as to third persons the profit-sharing test is often applied. No one test seems to be conclusive, the existence

elements of a general partnership are community of ownership of the partnership property, mutual responsibility and powers in the conduct of the partnership business, mutual liability, joint and several, for the debts of the partnership and mutual interest in the profits of the same. Such partnerships are not subject to the tax, but the partners are taxed on their respective shares of the profits.[12]

Partnerships Consisting of Corporations. In a case arising under the 1913 Law several corporations, organized under the laws of Hawaii entered into a partnership with one another, the laws of Hawaii permitting such a combination for the transaction of any lawful business. The by-laws provided for management by representatives selected by the several partners who were to represent the partners according to their respective interests. There were no special partners and there was no partnership capital stock. The by-laws provided for the existence of the association for 45 years unless sooner terminated by mutual consent. It was held that this provision did not show any plan for changeability in the membership; that dissolution would probably be effected through the transfer of any partner's interest; and that the association must be treated for income tax purposes as a partnership.[13] But the participation of two corporations in a joint enterprise would not constitute them partners.[14]

Partnerships Operating Abroad. No distinction is made in the law or regulations between domestic partnerships which operate entirely within this country and those which operate partly abroad. A partner's share of the net profits of the partnership is in all cases taxable in full if the partner is a resident or citizen of this country. If a partner is a non-resident alien many questions arise as to the extent to which he is properly taxable on the gains from business of the partnership conducted abroad. If the partnership is a limited partnership association under the provisions of some statute, similar to the Pennsylvania statute, the

of a partnership being a question of fact upon which all the various tests may bear. (See Meehan v. Valentine, 145 U. S. 611; Haiku Sugar Co. v. Johnstone, 249 Fed. 103.)

12 Revenue Act of 1918, § 218.

13 Haiku Sugar Co. v. Johnstone, 249 Fed. 103. This case contains a discussion of the distinction between joint-stock companies and partnerships.

14 Reg. 45, Art. 1507.

Government will undoubtedly hold that the partner is taxable to the same extent as though it were a corporation, but if it is a general partnership operating partly in a foreign country, the entire income therefrom can scarcely be considered as income arising within the United States, even though the partnership has an office in this country and the income is paid to the partner from that office, since a general partnership is not a separate entity interposed between the individual and the source of the income.[15]

Procedure in Collecting Income. With one exception, a domestic partnership is not subject to withholding at the source. But a partnership may be required to establish its identity and status by filing a certificate or statement showing it to be a partnership.[16] A new provision of the Revenue Act of 1918 requires withholding at the source against partnerships in the case of interest on bonds, mortgages, or deeds of trust, or other similar obligations containing a so-called "tax-free covenant," thus giving partnerships as well as individuals the benefit of such covenants.[17] Partnerships as well as all other recipients of income will be required to disclose their identity in the case of receiving fixed and determinable income from another under the provisions of law requiring information at the source.[18]

Duty in Paying Out Income. A partnership is under the same duty in paying out income as is an individual or a corporation; that is, in all cases required by law the tax must be withheld on payments of income to non-resident aliens and non-resident foreign corporations[19] and information as to the name and address of the recipient must be obtained upon the payment of income to other individuals, partnerships or corporations.[20]

15 U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27. A distinction is now made by the Treasury Department between domestic corporations operating entirely within this country and those operating entirely abroad. (Reg. 45, Art. 92.)

16 Revenue Act of 1913, § 221; T. D. 1957, T. D. 1998; Telegram from Treasury Department dated May 17, 1918; I. T. S. 1918, ¶ 3362. See Chapter 40.

17 Revenue Act of 1918, § 221. See Chapter 40.

18 See Chapter 39.

19 Revenue Act of 1918, §§ 221 and 237.

20 See Chapters 39 and 40.

Net Income of Partnerships. The net income of a partnership is computed in the same manner and on the same basis as the net income of an individual except that a partnership is, unlike individuals, not allowed to deduct charitable contributions or gifts made within the taxable year.[21] The proceeds of life insurance policies paid upon the death of the insured to partnership beneficiaries need not be included in the gross income of the partnership.[22]

Deductions. The deductions to which a partnership is entitled are the same as those allowed to individuals with the exception noted in the preceding paragraph.[23] In the case of limited partnerships of the Pennsylvania type reporting as corporations, the deductions should be made under the rules applicable to corporations. Certain special rulings made with respect to deductions by partnerships are given below.

PROFIT SHARING. It has been held that an arrangement whereby a partnership agreed with an expert to take charge of one of its departments upon a participation of profits basis, by which the expert served without salary and received his compensation in the form of 20% of the net profits of the department at the end of the year, established the relation of employer and employee, and that the compensation paid to the expert constituted a proper item of business expense to be deducted in computing the net income accruing to the partnership members.[24]

[21] Revenue Act of 1918, § 218 (d); Reg. 45, Art. 321. For the manner of computing the net income of partnerships under the 1916 Law, see Reg. 33 Rev., Art. 30. It seems that the partners may consider the contributions of the partnership as their own contributions, pro rata. Under the 1916 Law, partnerships were not permitted to deduct the amount of their Red Cross contributions, but the partners in computing their individual income taxes might deduct their proportionate amounts of such contributions subject, of course, to the 15% limitation. (Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436.) Certain donations immediately and closely connected with the business of a partnership were held deductible under the 1916 Law. (Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437.) This subject is more fully considered in a later paragraph.

[22] Letter from Treasury Department dated November 18, 1919; I. T. S. 1919, ¶ 3642.

[23] Revenue Act of 1918, §§ 218 (d), 212.

[24] Letter from Treasury Department dated June 30, 1916; I. T. S. 1919, ¶ 1297.

INSURANCE PREMIUMS. Premiums paid on life insurance policies covering the life of an officer, employee or of any person financially interested in any business conducted as a partnership are not permitted to be deducted in computing the profits of a partnership for the purpose of determining the distributive shares of the partners.[25] On the maturity of such policies the premiums paid (if not deducted from the net income of the years in which paid) are a proper deduction from the amount of the policy, the remainder constituting the taxable portion of the amount received.[26]

Distribution of Partnership Profits. The law has not been construed at any time to require the collection of the tax at the source on the distribution and payment of the profits of a partnership to the partners. No ruling has appeared expressly requiring such deduction on payments to non-resident alien partners.[27]

Profits to Be Reported by Partners. Income of a partnership accrues to the individual partner at the time his distributive interest is determined.[28] The distributive share of the net income of a partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (a) for the taxable year upon the basis of which the partner's net income is computed, or (b) if the partner's net income is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, for any taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed. Amounts earned and distributed to a partner by a partnership after the end of its taxable year and before the end of his corresponding taxable year should be accounted for both by the partnership and by the partner in their returns for their next

25 Revenue Act of 1918, § 215 (d); Revenue Act of 1916, as amended by the Revenue Act of 1917, § 32 (the reference to § 9 is apparently a mistake, the reference being intended to § 8 (e)). See Reg. 33 Rev., Art. 30. Under the 1916 Law, prior to the 1917 amendment, the Treasury Department permitted such premiums on life insurance to be deducted from year to year as paid and required the amount of the policy to be included in gross income in the year in which the policy matured and such amount was received. (T. D. 2090.)

26 Letter from Treasury Department dated March 15, 1918; I. T. S. 1918, ¶ 3290.

27 See I. T. S. 1918, ¶ 665. See Chapter 40.

28 Reg. 33 Rev., Art. 4.

succeeding taxable years.[29] Both normal and surtaxes must be paid, upon this distributive share, except as noted below. When the annual profits are not distributed and paid to the partners, the respective interests of each partner in the undistributed profits for the year should be ascertained and the partners entitled thereto should include the amount of their respective interests in their returns as if the profits had been distributed and paid to them.[30] Such undivided annual profits of partnerships having been reported by the individual members thereof and the tax having been paid thereon, are not again taxable to the partners when actually distributed at a later date.[31] The distributive interests of the partners in the firm's net income should be the amount shown by the books when closed and not their distributive interests in the amount of income of the partnership represented by actual cash receipts, unless the partnership keeps its books on the basis of cash receipts and disbursements. Where accounts receivable, for instance, are entered on the books of the partnership as income and are treated as debts due from customers or clients, the partners' returns are required to be based on the total sum of such accounts receivable and not on the amount thereof that has actually been paid.[32] A portion of the net income of the partnership for the taxable year may represent dividends or interest exempt from normal tax, interest from corporate bonds containing "tax-free covenants" and interest on bonds which may be wholly exempt from income tax, in which case the rules stated in the following paragraphs apply.

DIVIDENDS. For the purpose of the normal tax a partner is allowed a credit of his proportionate share of the income received by the partnership as dividends from (a) a corporation which is taxable upon its net income, and (b) a personal service corporation out of earnings or profits upon which income tax has been imposed.[33]

INTEREST ON NATIONAL BONDS. For the purpose of the normal tax only, a partner is allowed a credit of his proportionate share

[29] Reg. 45, Art. 322.

[30] Reg. 33, Art. 13. Revenue Act of 1918, § 218 (a).

[31] Reg. 33, Art. 14. Revenue Act of 1918, § 218 (a).

[32] Letter from Treasury Department dated February 28, 1916; I. T. S. 1919, ¶ 1285. See also Revenue Act of 1918, § 212 (b).

[33] Revenue Act of 1918, § 218 (a); Reg. 45, Art. 323. See Chapter 19.

of the income received by the partnership as interest upon the obligations of the United States and bonds issued by the War Finance Corporation which is included in the gross income of the partnership.[34] This credit of interest on national bonds for the purpose of the normal tax is unrestricted, because the interest on all national bonds is exempt from the normal tax. Interest upon obligations of the United States issued after September 1, 1917, and War Finance Corporation bonds is exempt from the surtax only to a limited extent and as provided in the respective acts authorizing the issue of such obligations or bonds, as amended and supplemented.[35] The Revenue Act of 1918 provides that in the case of such obligations or bonds the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and war-profits and excess-profits taxes.[36] As income of a partnership is taxable to the individual partners, each partner is treated as the owner of a proportionate part of the bonds held by the partnership and is entitled to exemption on account of such partnership as if such partner owned such proportionate part of the bonds directly. Such partner, if a partner at the time of the original subscription by the partnership for bonds of the Fourth Liberty Loan or notes of the Victory Liberty Loan, as the case may be, is treated as an original subscriber for a proportionate part of such bonds or notes subscribed for by the partnership and is entitled to the appropriate collateral exemption of interest on bonds of previous issues on account of such original subscription for bonds or notes as if he had subscribed directly for such proportionate part.[37]

34 Revenue Act of 1918, §§ 218 (a), 216 (b); Reg. 45, Art. 323.

35 The amount of the exemption in the case of each issue is discussed in Chapter 18.

36 Revenue Act of 1918, § 213 (a) 4.

37 Reg. 45, Art. 82; T. D. 2762. This principle also applies to stockholders in personal service corporations. Under the 1916 Law, as amended, interest upon the obligations of the United States issued after September 24, 1917, was required to be included in gross income of a partnership only to the extent to which the partnership's holdings exceeded $5,000 par value (see Form No. 1065), this being the exemption granted in the Second Liberty Bond Act for purposes of the surtaxes then in force.

INTEREST ON BONDS OF STATES, POSSESSIONS AND POLITICAL SUBDIVISIONS. The interest received by the partnership on the obligations of a State or any political or taxing subdivision thereor and upon the obligations of the possessions of the United States might, under the 1916 Law, be deducted by a partner in proportion to his share of the total partnership profits.[38] It was unnecessary to provide for this deduction or credit under the Revenue Act of 1918, since such interest, as well as interest upon obligations of a territory or any political subdivision thereof or the District of Columbia and securities issued under the Federal Farm Loan Act, is excluded from gross income,[39] and will not appear in the net income of the partnership, which consists of its gross income less deductions.

CREDIT FOR TAXES. The provision of the Revenue Act of 1918 that the tax computed shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States is discussed elsewhere in this book.[40] Where such taxes have been paid by a partnership, the income tax of an individual member thereof will be credited with the member's proportionate share of such taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, as the case may be. A partner, who is an alien resident of the United States and a citizen or subject of a foreign country, is entitled to such credit only for taxes paid or accrued to a pos-

38 This was undoubtedly intended to give the partner the benefit of the same exemption as was accorded to individuals or corporations under § 4 of the Revenue Act of 1916, although that section referred only to "political subdivisions" while the provision relating to partnerships refers to "political and taxing subdivisions." However, political subdivision has been construed to mean any subdivision of a state having the power to levy taxes so that the inclusion of the phrase "taxing subdivision" apparently did not extend any greater exemption to partners than to others.

39 Revenue Act of 1918, § 213 (b). It is provided that every person (the term "person" including partnerships) owning any of the obligations, securities or bonds enumerated in the law to be absolutely exempt from the income tax—which includes the bonds referred to in the text above—shall in his return of income submit a statement showing the number and amount of such obligations, securities or bonds owned by him and the income received therefrom in such form and with such information as the Commissioner may require. (Revenue Act of 1918, § 213 (b) 4.)

40 See Chapter 32.

session of the United States, or to the foreign country of which he is a citizen or subject, and is not entitled to such credit for taxes paid or accrued to that country unless it allows a similar credit to a citizen of the United States residing therein.[41]

READJUSTMENT OF PARTNERSHIP INTERESTS. When a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him, or (if acquired prior thereto) the fair market value as of March 1, 1913, of his interest in the partnership, including in such cost or value the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid. If, however, the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received on distribution. Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain or loss has been realized by any partner.[42]

Fiscal Year. The net income of a partnership is computed generally in the same manner and on the same basis as the net income of individuals.[43] Its net income must be computed upon the basis of the partnership's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of the partnership. If no such method of accounting has been employed, or if the method employed does not clearly reflect income, the computation is made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income. If the partnership's annual accounting period is other than a fiscal year, or if the partnership has no annual accounting period or does not keep books, its net income will be computed on the basis of the calendar year.[44] If the net income of a partner is computed

41 Revenue Act of 1918, § 222 (a) 4; Reg. 45, Art. 323.

42 Reg. 45, Art. 1570.

43 Revenue Act of 1918, § 218 (d).

44 Revenue Act of 1918, § 212 (b). Prior to the enactment of the Revenue Act of 1918 reporting on the basis of a fiscal year was a privilege; now it is a requirement, if the books of the partnership are kept on the basis of a fiscal

on the basis of a period different from that upon the basis of which the net income of the partnership is computed, then the partner's distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the fiscal year or calendar year upon the basis of which the partner's net income is computed, is included in computing the net income of each partner.[45] If the fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends apply to the remainder.[46]

TAXATION OF PARTNERS IN PARTNERSHIP WITH FISCAL YEAR ENDING IN 1919. If the fiscal year of a partnership began in the calendar year 1918 and ends in the calendar year 1919, the rates of tax for the calendar year 1918 apply to the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1918, and the rates

year. (See Chapter 34.) Under the 1916 Law a partnership had the same privilege of fixing and making returns upon the basis of its own fiscal year as was accorded to corporations. If a fiscal year ended during 1916 or during a subsequent calendar year for which there was a rate of tax different from the rate of the preceding calendar year, the rate for the preceding calendar year applied to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such preceding calendar year bore to the full fiscal year and the rate for the calendar year during which such fiscal year ended applied to the remainder of such profits. (Revenue Act of 1916, § 8 (e) as amended by the Revenue Act of 1917.) Prior to this amendment of the statute the Treasury Department held that where the fiscal year of a partnership ended at any time other than December 31st the total profits of the partnership were required to be reported as income of the partners for the calendar year in which the fiscal year of the partnership ended.

[45] Revenue Act of 1918, § 218 (a).

[46] Revenue Act of 1918, § 218 (b). In the case of an individual member of a partnership making return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, was deducted from that part of the income subject to the 1917 rates, and not from that part subject to the 1918 rates. (Revenue Act of 1918, § 218 (c).)

for the calendar year 1919 to the amount of each partner's distributive share of such net income of the partnership attributable to the calendar year 1919. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1918 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1918 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1918 bears to the full fiscal year. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1919 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1919 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1919 bears to the full fiscal year.[47]

Application of Different Tax Rates in the Case of Fiscal Year of Partnership Ending in 1919. Any deductions, exemptions or credits to which the partner in a partnership with a fiscal year ending in 1919 is entitled should first be applied against his income subject to the rates for the calendar year 1919, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1918. In determining the rates of tax applicable to the amounts of the distributive shares of the partners attributable to the calendar years 1918 and 1919, respectively, the amounts subject to the rates for the calendar year 1919 should be placed in the lower brackets of the rate schedule provided in the statute, and the amounts attributable to the calendar year 1918 in the next higher brackets of the rate schedule applicable to that year.[48]

Net Losses of Partnership. Where the result of partnership operation is a net loss, the loss will be divisible between the partners in the same proportion as a profit would have been

[47] Reg. 45, Art. 326. For the rule in the case of partnerships with fiscal years ending in 1918 and the application of the different tax rates in such cases, see Reg. 45, Arts. 324-325.

[48] Reg. 45, Art. 327.

divisible, and may be used by the individual partners in their returns of income,[49] as the loss of a partnership is considered to be a loss sustained in trade by the individual members. The partner may deduct the loss whether he is compelled to make good his proportionate share by payment of money to the partnership or whether the loss is charged against profits accrued to his account in preceding years.[50] If the loss occurs in a fiscal year covering a period in which there is a change of tax rates it does not seem that the loss should be pro-rated although the income, if any, would be, since a loss is deductible in the year in which it is actually sustained.[51]

Profits Earned Prior to March 1, 1913. In a case arising under the 1913 Law it was contended that where the fiscal year of a partnership ended between March 1, 1913, and December 31st of the same year, the equitable method would be to apportion the profits for the fiscal year in equal monthly installments and allot to the period preceding March 1st its proper proportion, making the partners taxable only on their respective shares in the remainder. The court held that the plaintiff in this case failed to show that profits were earned by the partnership prior to March 1, 1913, and in what sum, and in the absence of such showing the court assumed that the tax was legally collected.[52] The Treasury Department held under the 1913 Law that the entire amount of profits accruing to a partner at the close of the fiscal year of the partnership were taxable in the calendar year in which the fiscal year ended,[53] although a part of the fiscal year may have covered a period prior to the incidence of the tax.

Returns by Partnerships. Every partnership must make a return of income, regardless of the amount of its net income. The return should be on form 1065 (revised) and should be sworn to by one of the partners. Such return should be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year as the case may be), irrespec-

49 Reg. 33 Rev., Art. 30.

50 Letter from Treasury Department dated February 12, 1915; I. T. S. 1918, ¶ 674.

51 See Chapter 25.

52 Cohen v. Lowe, 234 Fed. 474.

53 T. D. 2090.

tive of the taxable years of the partners.[54] A receiver in charge of the business of a partnership must make a return for it on form 1065 (revised).

CONTENTS OF PARTNERSHIP RETURN. The return of a partnership should state specifically (a) the items of its gross income; (b) the deductions to which it is entitled under the law; (c) the amounts of dividends from taxable corporations and from personal service corporations out of earnings and profits upon which income tax has been imposed, and of interest upon obligations of the United States and bonds of the War Finance Corporation included in gross income; (d) the amount of any income, war-profits and excess-profits taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the names and addresses of the individuals who would be entitled to share in the net income of the partnership if distributed; (f) the amount of the distributive share of such net income of each such individual; and (g) such other facts as are required by form 1065 (revised).[55]

RETURNS OF TAX WITHHELD AT SOURCE. Partnerships are required to make returns on or before March first of each year of amounts of tax required to be withheld at the source.[56]

[54] Revenue Act of 1918, § 224; Reg. 45, Arts. 411 and 412. If the partnership makes any change in its accounting period, it should make its return in accordance with the provisions of § 226 of the Statute and Reg. 45, Art. 431. Prior to the enactment of this provision partnerships as such were not required to render annual returns of income, but when requested by the Commissioner, or any collector, were required to make a correct return of earnings, profits and income, showing their gross income and the deductions and credits allowed by the law and the names and addresses of the individuals who would be entitled to the net earnings, profits and income if distributed. It was not required in such returns that the partnership report income exempt under § 4 of the 1916 law. (Revenue Act of 1916, § 8 (e); Reg. 33 Rev., Art. 30; Reg. 33, Art. 12.) Special returns from partnerships were required generally in 1913, but no returns were required for the year 1914 or for subsequent years, except in instances where it was specially required by the Commissioner or a collector. In 1917 partnerships were required to file returns of income for the excess profits tax.

[55] Reg. 45, Art. 412.

[56] Revenue Act of 1918, §§ 221 (c) and 237; Reg. 45, Arts. 361-376; see Chapter 40.

Returns of Information. Partnerships are required to file such returns as are required under the provisions of law relating to information at the source.[57]

Reports by Brokers. Every partnership doing business as a broker is required, when called upon by the Commissioner, to make a return showing the names of its customers with such details as to the profits, losses or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on the profits or gains of such customers has been paid.[58] This report is for the purpose of information at the source and is more fully discussed in another chapter.[59]

Penalties. Partnerships or their members or employees are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make returns, to supply information, to pay or collect any tax, or for wilfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[60]

Examination of Partnership Records. All partnership books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the Commissioner for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in accordance with and subject to rules which are discussed at length in another chapter.[61]

Foreign Partnerships. The distinction between domestic and foreign partnerships is given above.[62] The Revenue Act of 1918 does not use the word "foreign" in connection with partnerships in the part of the Act imposing the income tax.[63] The Act, however, provides that individuals carrying on business in partnership shall be liable for income tax in their individual capacity. This implies that the income of a foreign partnership from sources

57 Revenue Act of 1918, § 256; Reg. 45, Arts. 1071-1080.

58 Revenue Act of 1918, § 255; Reg. 45, Art. 1061.

59 See Chapter 39.

60 See Chapter 36.

61 See Chapter 38.

62 See p. 106.

63 The term "foreign" is applied to partnerships in the title imposing Stamp Taxes. (Revenue Act of 1918, § 1107, Title XI, Schedule A-15.)

within the United States is taxable in the hands of the non-resident alien partners, to the extent included in the distributive share of each, and such has been the ruling of the Treasury Department.[64] The income received by a non-resident alien partnership from sources within the United States does not, like the income received by a domestic or resident alien partnership, lose its identity as to source when distributed to a non-resident alien member of a firm.[65] If the partner is a citizen or resident of this country, he is of course subject to tax upon his entire distributive share of the profits of any partnership of which he may be a member. Foreign partnerships are divided into two classes: (1) resident foreign partnerships, and (2) non-resident foreign partnerships. A foreign partnership which is engaged in business or trade within the United States and has an office or place of business herein is a resident foreign partnership, and a foreign partnership which is not engaged in business or trade within the United States and has no office or place of business herein is a non-resident foreign partnership.

Extent to Which Taxable. Foreign partnerships, unless they are of the kind taxable as corporations,[66] are not taxable, but the partners are required to pay the tax in all cases on their distributive shares of the profits, gains or income of the partnership arising from sources within the United States. Thus, in the case of resident foreign partnerships, the income from the business transacted in the United States and from investments in this country is taxable. In the case of a non-resident foreign partnership, income from investments in this country and gains from the buying and selling of property of any kind in this country are taxable.[67] The law expressly provides that amounts received (although paid under a contract for the sale of goods or otherwise)

[64] Letter from Treasury Department dated April 7, 1917; I. T. S. 1918, ¶ 702; Letter from Treasury Department dated June 6, 1918; I. T. S. 1918, ¶ 3528; Letter from Treasury Department dated October 1, 1918; I. T. S. 1919, ¶ 521; Letter from Treasury Department dated December 6, 1916; I. T. S. 1919, ¶ 522.

[65] Letter from Treasury Department dated October 1, 1918; I. T. S. 1919, ¶ 521.

[66] See the discussion of Limited Partnerships on page 107.

[67] Letter from Treasury Department dated December 6, 1916; I. T. S. 1919, ¶ 522.

representing profits on the manufacture and disposition of goods within the United States are income from sources within the United States.[68]

COLLECTION OF THE TAX AT THE SOURCE. Under the Revenue Act of 1918, a partnership, resident or non-resident, is not subject to having any tax withheld at the source on income from sources in this country, except in the case of interest upon bonds of corporations containing covenants to pay the tax.[69] The Treasury Department under the 1916 Law made no distinction based upon the status of the individual partners and no such distinction is made under the present law.[70]

PROCEDURE IN COLLECTING INCOME. In collecting income from interest on bonds not containing a "tax-free covenant" a resident or non-resident foreign partnership makes use of a form certifying that it is not subject to having the income tax withheld at

[68] Revenue Act of 1918, § 213 (c); Reg. 45, Art. 91. A further discussion of the term "sources within the United States" is contained in Chapter 4.

[69] Revenue Act of 1918, § 221 (b); Reg. 45, Art. 361. Withholding was not required in any case on payments to a resident foreign partnership under the 1916 Law. Non-resident foreign partnerships were also not subject to having the tax withheld on interest from investments in the bonds or similar obligations of domestic or resident corporations (Telegram from Treasury Department dated May 17, 1918, I. T. S. 1918, ¶ 3362.) or on dividends (Reg. 33 Rev., Art. 32; Letter from Treasury Department dated June 6, 1918; I. T. S. 1918, ¶ 3528) on the stock of corporations or other income. The language of the Revenue Act of 1916, § 13 (e), as amended, was ambiguous. It provided that the provisions relating to withholding of the tax should be made applicable "to the tax imposed by Subdivision (a) of § 10 upon incomes derived from interest upon bonds and mortgages or deeds of trusts or similar obligations of domestic or other resident corporations * * * by non-resident alien firms." No tax, as a matter of fact, was imposed upon firms or partnerships by Subdivision (a) of § 10, and consequently it was ruled that no tax need be withheld.

[70] Telegram from Treasury Department dated May 17, 1918; I. T. S. 1918, ¶ 3362. It is interesting to note in this connection that immediately after the 1913 Law was enacted and before it was held that partnerships were not subject to withholding the Treasury Department provided for the use of partnerships an ownership certificate which required a statement of the names and addresses of each of the partners. No such disclosure of the names of the partners of non-resident foreign partnerships was subsequently required, which indicates that the Treasury Department did not consider the individual status of the partners to be essential in determining whether or not withholding is necessary.

the source.[71] In collecting any other form of income no prescribed certificate is necessary, but the partnership may be called upon to disclose its name and location for the purpose of supplying the payor of the income with the information which he is required to transmit to the Government.[72]

DUTY IN PAYING OUT INCOME. Resident foreign partnerships are under the same duty in paying out income to others as are domestic partnerships; that is, they are required to withhold on payments made from the office in this country under the same conditions which require domestic partnerships to withhold. They are also required to report the names of those to whom they pay fixed or determinable income, in the manner required by law of corporations, partnerships, and individuals generally.[73]

71 Reg. 45, Art. 365. Form No. 1001 (revised) is used for this purpose.

72 For the 1916 procedure in this respect see Reg. 33 Rev., Art. 43. Telegram from Treasury Department dated May 21, 1918; I. T. S. 1918, ¶ 3364. See I. T. S. 1918, ¶ 3452a.

73 See Chapters 39 and 40.

CHAPTER 9

PERSONAL SERVICE CORPORATIONS

In an attempt to equalize the relative tax burdens of corporations and partnerships the Revenue Act of 1918 prescribes a new system of taxation for a certain type of corporation, which it calls a personal service corporation. Personal service corporations are corporations whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor. The term "personal service corporation" does not include, however, any foreign corporation, or any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[1] Personal service corporations as such are not subject to income tax, the individual stockholders thereof being taxed in the same manner as the members of partnerships.[2] All the provisions of law discussed in the preceding chapter relating to partnerships and the members thereof apply, so far as practicable, to personal service corporations and the stockholders thereof, provided that amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees (i. e., the persons who actually receive the dividends); and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable

[1] Revenue Act of 1918, § 200. For a definition of the term "Government contract" see Reg. 45, Art. 1510.

[2] Reg. 45, Art. 328. In making returns for fiscal years beginning in 1917, personal service corporations were not treated wholly as such. See below, page 135.

year in proportion to their respective shares.[3] Thus, the individual stockholders of personal service corporations are taxable upon their distributive shares in the same manner as the members of partnerships, and the corporation is subject to neither income nor excess-profits taxes.[4]

Definition. The statutory definition of personal service corporations has been given above. By regulation the term "personal service corporation" is defined as a corporation, not expressly excluded, the income of which is derived from a profession or business (a) which consists principally of rendering personal service, (b) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (c) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal service corporation.[5] The general principles under which such determination will be made are stated in the following paragraphs.

CERTAIN CORPORATIONS EXCLUDED. The following classes of corporations are expressly excluded from classification as personal service corporations: (a) foreign corporations; (b) corporations 50 per centum or more of whose gross income consists of gains, profits or income derived from trading as a principal; and (c) corporations 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, inclusive. A corporation is not a personal service corporation merely because less than 50 per centum of its gross income was derived from trading as a principal or from Government contracts. A corporation can not be considered a personal service corporation when another corporation owns or controls substantially all of its stock, or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests.[6]

3 Revenue Act of 1918, § 218 (e).
4 Reg. 45, Art. 328.
5 Reg. 45, Art. 1523.
6 Reg. 45, Art. 1524.

PERSONAL SERVICES RENDERED BY PERSONAL SERVICE CORPORATION. In order that a corporation may be deemed to be a personal service corporation its earnings must be derived principally from compensation for personal services rendered by the corporation to the persons with whom it does business. Merchandising or trading either directly or indirectly in commodities or the services of others is not rendering personal service. Conducting an auction, agency, brokerage, or commission business strictly on the basis of a fee or commission is rendering personal service. If, however, the corporation assumes any such risks as those of market fluctuation, bad debts, failure to accept shipments, etc., or if it guarantees the accounts of the purchaser or is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary.[7]

PERSONAL SERVICE RENDERED BY PERSONAL SERVICE CORPORATION: MORE THAN ONE BUSINESS. It frequently happens that corporations are engaged in two or more professions or businesses which are more or less related, one of which does not consist of rendering personal service. Thus an engineering concern may also engage in contracting, which amounts to trading in materials and labor, a brokerage concern may guarantee some of its accounts, a photographer may sell pictures, frames, art goods, and supplies, or a dealer in a commodity may furnish expert advice or services with respect to its installation, use, etc. In such case the corporation is not a personal service corporation unless the non-personal service element is negligible or merely incidental and no appreciable part of its earnings is to be ascribed to such sources.[8]

ACTIVITIES OF STOCKHOLDERS OF PERSONAL SERVICE CORPORATION. In determining whether a corporation is a personal service corpo-

[7] Reg. 45, Art. 1525.
[8] Reg. 45, Art. 1526.

ration, no weight can be given to the fact that it renders personal services unless (a) the principal owners or stockholders are regularly engaged in the active conduct of its affairs and are engaged in such a manner that the earnings are to be ascribed primarily to their activities, and (b) its affairs are conducted principally by such owners or stockholders.[9]

ACTIVITIES OF STOCKHOLDERS OF PERSONAL SERVICE CORPORATION: CONDUCT OF AFFAIRS. Where the principal owners or stockholders do not render the principal part of the services, but merely supervise or direct a force of employees, the corporation is not a personal service corporation. If employees contribute substantially to the services rendered by a corporation, it is not a personal service corporation unless in every case in which services are so rendered the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the principal owners or stockholders and such fact is evidenced in some definite manner in the normal course of the profession or business. The fact that the principal owners or stockholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business, the principal owners or stockholders of which do not devote personal attention to the management or supervision of its affairs, does not of itself constitute the corporation a personal service corporation.[10]

ACTIVITIES OF STOCKHOLDERS OF PERSONAL SERVICE CORPORATION: STOCK INTEREST REQUIRED. No definite percentage of stock or interest in the corporation which must be held by those engaged in the active conduct of its affairs in order that they may be deemed to be the principal owners or stockholders can be prescribed as a conclusive test, as other facts may affect any presumption so established. No corporation or its owners or stockholders may, however, make a return in the first instance on the basis of its being a personal service corporation unless at least 80 per centum of its stock is held by those regularly engaged in the active conduct of its affairs.[11]

ACTIVITIES OF STOCKHOLDERS OF PERSONAL SERVICE CORPORATION: CHANGE IN OWNERSHIP. The fact that the owners or stock-

[9] Reg. 45, Art. 1527.
[10] Reg. 45, Art. 1528.
[11] Reg. 45, Art. 1529.

holders of the corporation may change during the course of the taxable year does not take a corporation which is normally in the personal service class out of that class. Frequent changes in the ownership of any substantial interest or number of shares is, however, evidence bearing on the question as to whether the principal owners or stockholders are actively engaged in the conduct of the affairs of the corporation. The incapacity, retirement or death of a principal owner or stockholder who has been actively engaged in the conduct of its affairs will not be deemed to make any change in the status of the corporation during a reasonable time thereafter.[12]

CAPITAL OF PERSONAL SERVICE CORPORATION. In determining whether a corporation is a personal service corporation, no weight can be given to the fact that the invested capital for purposes of the excess-profits tax or the actual investment of the principal owners or stockholders is comparatively small. The test established by the statute with respect to capital is entirely different. That test is the nature of the profession or business as indicated (a) by the kind of services it renders and (b) the extent to which capital is required to carry on such profession or business. If the use of capital is necessary or more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. No corporation is a personal service corporation if it carries on business of a kind which ordinarily requires the use of capital, irrespective of whether the owners or stockholders have actually invested a substantial amount of capital.[13]

CAPITAL OF PERSONAL SERVICE CORPORATION: INFERENCE FROM USE. The term "capital" means not only capital actually invested by the owners or stockholders, but also capital secured in other ways. Thus, if capital is borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable or other paper, or indirectly as shown by accounts payable or other forms of credit, or if the business of the corporation is in any way financed by or through any of the owners or stockholders, these facts will be deemed evidence that the use of capital is necessary. If a substantial amount of capital is used to finance

[12] Reg. 45, Art. 1530.
[13] Reg. 45, Art. 1531.

or carry the accounts of clients or customers, it will be inferred that because of competition or other reasons such practice is necessary in order to secure or hold business which otherwise would be lost, and that the corporation is not a personal service corporation. If a corporation engaged in an agency, brokerage, or commission business regularly employs a substantial amount of capital to lend to principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, it is not a personal service corporation. In general the larger the amount of the capital actually used the stronger is the evidence that capital is necessary and is a material income-producing factor and that the corporation is not a personal service corporation.[14]

Dividends of Personal Service Corporations. In the case of personal service corporations the term dividend means any distribution made by a personal service corporation to its shareholders or members, whether in cash or in property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[15] Any distribution is deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter will be deemed to have been made from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends, or otherwise, exempt from tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.[16]

Returns of Personal Service Corporations. Every personal service corporation must make a return of income, regardless of the amount of its net income. The return should be on Form 1065 (revised). It should be made for the taxable year of the personal service corporation; that is, for its annual accounting period (fiscal year or calendar year, as the case may be), regardless of the taxable years of its stockholders.[17]

[14] Reg. 45, Art. 1532.

[15] Revenue Act of 1918, § 200 (a). See Chapter 19.

[16] Revenue Act of 1918, § 200 (b). See Chapter 19.

[17] Reg. 45, Art. 624. If the personal service corporation makes any change in its accounting period, it should render its return in accordance with the provisions of § 226 of the Statute.

CONTENTS OF RETURN OF PERSONAL SERVICE CORPORATION. The return of a personal service corporation should state specifically (a) the items of its gross income; (b) the deductions to which it is entitled; (c) the amounts of dividends from taxable corporations and from personal service corporations out of earnings and profits upon which income tax has been imposed, and from interest upon obligations of the United States and bonds of the War Finance Corporation included in gross income; (d) the amount of any income, war-profits and excess-profits taxes of the personal service corporation paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the amounts distributed by the corporation during its taxable year with the dates of distribution; (f) the names and addresses of the stockholders of the corporation at the close of its taxable year and their respective shares in such corporation; (g) such facts as tend to show whether or not the corporation is a personal service corporation; and (h) such other facts as are required by the form.[18]

Distributive Shares of Stockholders in Personal Service Corporation. A stockholder of a personal service corporation is required to include in his gross income for the taxable year (a) any dividends paid by the corporation in such year out of earnings or profits accumulated since February 28, 1913, and before January 1, 1918; (b) his share of any distribution made by the corporation in such year out of earnings or profits accumulated since December 31, 1917, and since the close of its taxable year ending with or during his next preceding taxable year; and (c) his distributive share of the undistributed net income of the corporation for its taxable year ending with or during his taxable year, provided he was at the close of its taxable year a stockholder in the corporation, notwithstanding he might since have ceased to be a stockholder. In the case of personal service corporations with taxable years other than the calendar year, however, such distributive shares or distributions may be subject to different rates of tax.[19]

18 Reg. 45, Art. 624.

19 Reg. 45, Art. 330.

Credits Allowed Stockholders of Personal Service Corporation. A stockholder of a personal service corporation is entitled to credit for the purpose of the normal tax only for amounts received in distribution of earnings or profits of the corporation accumulated since February 28, 1913, and prior to January 1, 1918. In addition to the credits ordinarily allowed to an individual a stockholder of a personal service corporation is entitled to the following credits: (a) a credit against net income for the purpose of the normal tax only of his proportionate share of such dividends from a corporation subject to tax and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the personal service corporation, and (b) a credit against income tax of the stockholder's proportionate share of income, war-profits and excess-profits taxes of the personal service corporation paid or accrued during the taxable year to a foreign country upon income derived from sources therein, or to any possession of the United States.[80]

Taxation of Stockholders of Personal Service Corporation with Fiscal Year Ending in 1919. Such part of a stockholder's distributive share of the net income of a personal service corporation for its fiscal year ending in 1919 as is attributable to the calendar year 1919 is taxable at the rates for such calendar year, and such part of such distributive share as is attributable to the calendar year 1918 is taxable at the rates for such calendar year. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1919 is found by determining his distributive share of the net income of the corporation for its fiscal year, whether distributed or not, in the same manner as if the fiscal year were the calendar year 1919, and then taking the proportion thereof which the part of such fiscal year falling within such calendar year bears to the full fiscal year. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1918 is found by determining his distributive share of the net income of the corporation for its fiscal year, whether distributed or not, in the same manner as if the fiscal

80 Reg. 45, Art. 331. The credit stated in (b) is of course subject to the limitations of § 222 of the Statute.

year were the calendar year 1918, and then taking the proportion thereof which the part of such fiscal year falling within such calendar year bears to the full fiscal year. The stockholder is also liable to tax on dividends received out of earnings or profits accumulated since February 28, 1913, and before January 1, 1918.[21]

Application of Different Tax Rates in the Case of Fiscal Year of Personal Service Corporation Ending in 1919. Any deductions, exemptions or credits to which the stockholder of a personal service corporation with a fiscal year ending in 1919 is entitled should first be applied against his income subject to the rates for the calendar year 1919, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1918. In determining the rates of tax applicable to the amounts of the distributive shares of the stockholders attributable to the calendar years 1918 and 1919, respectively, the amounts subject to the rates for the calendar year 1919 should be placed in the lower brackets of the rate schedule provided in the statute and the amounts attributable to the calendar year 1918 in the next higher brackets of the rate schedule applicable to that year.[22]

Corporations Formed to Evade the Surtaxes. If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate, instead of being divided or distributed, the stockholders of such corporation will be subject to income tax in the same manner as the stockholders of a personal service corporation.[23]

21 Reg. 45, Art. 334. For the rule in the case of personal service corporations with fiscal years ending in 1918 and the taxation of the stockholders of such personal service corporations, see Reg. 45, Arts. 329, 332.

22 Reg. 45, Art. 335. For the rule in the case of personal service corporations with fiscal years ending in 1918 and the application of the different tax rates in such cases, see Reg. 45, Arts. 329, 333.

23 Revenue Act of 1918, § 220. For a full discussion of this subject see Chapter 2.

CHAPTER 10

CORPORATIONS

Corporations are taxed as separate entities apart from their stockholders. They are subject to a tax of 10% upon their net income for the year 1919 and subsequent years.[1] This tax is in lieu of the taxes imposed by the 1916 Law[2] as amended by the 1917 Law.[3] Corporations are not subject to the surtaxes.[4] They are entitled to deduct from their gross income, which (except in the case of insurance companies) is computed in the same manner as the gross income of individuals,[5] the deductions and credits specified in the law,[6] which differ to some extent from the deductions and credits allowed to individuals. Corporations, like individuals, make returns for the calendar or their fiscal year, according to the annual accounting period employed in keeping their books.[7] The mere existence of a corporation during any part of the year is sufficient to require it to make a return.[8] Prior to the present law, the mere receipt of net income from any source made it liable for the tax, but it may now be in receipt of net income without being liable for the tax if the credits to which it is entitled equal or exceed such net income.[9] Thus, a corporation may be in receipt of net income not in excess of $2,000 and be entitled to a credit of $2,000 against such net income for the purpose of the income tax, as a result of which it will be in receipt

1 Revenue Act of 1918, § 230. This rate was 12% for the calendar year 1918. Transportation systems are taxable as to part of this rate by amendment of the 1917 Law. See paragraph on Transportation Systems, post.

2 Revenue Act of 1916, § 10. The total tax to which corporations were subject under both the 1916 and the 1917 Laws was 6%.

3 Revenue Act of 1917, § 4.

4 See Reg. 33, Art. 185. The excess-profits tax is in effect a corporate surtax.

5 Revenue Act of 1918, § 233.

6 Revenue Act of 1918, §§ 234 and 236.

7 Revenue Act of 1918, §§ 200 and 232.

8 T. D. 2090. Revenue Act of 1918, § 239.

9 Revenue Act of 1918, §§ 234 and 236.

of net income without being liable for the tax. Since the tax is an income tax and not an excise tax,[10] doing business is not a necessary element of taxability.[11] Certain special provisions of the law applicable only to insurance companies are discussed in another chapter.[12]

Definition. The tax is imposed on every corporation, domestic or foreign. The word "corporation" is used in this chapter as defined in the present law,[13] and includes associations, joint-stock companies, and insurance companies.

JOINT-STOCK COMPANIES AND ASSOCIATIONS.[14] There seems to be no constitutional or legal objection to including joint-stock com-

10 The tax assessed on corporations for the months of January and February, 1913, under the 1913 Law, was an excise tax and not an income tax and, therefore, applied only to corporations "doing business," but the exemptions and deductions to which a corporation was entitled were those allowed by the 1913 Law, which law did not permit the deduction of dividends. (Butterick Company v. U. S., 240 Fed. 539.)

11 The numerous cases under the 1909 Law holding certain corporations not to be taxable on the ground that they were not "doing business" have no application to the *income* tax laws.

12 See Chapter 11.

13 Revenue Act of 1918, § 1. As used in the regulations issued under the 1916 Law, the term "corporation" was construed to include all corporations, joint-stock companies and associations, and all insurance companies coming within the terms of the law as well as all business trusts organized or created for the purpose of engaging in commercial or industrial enterprises, the capital of which was evidenced by certificates or shares of interest issued or issuable to members on the basis of which profits were distributed or distributable. (Reg. 33 Rev., Art. 57.)

14 The 1909 Law taxed "Every corporation, joint-stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia." (Act of August 5, 1909, § 38.) The 1913 Law taxed "Every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." (Act of October 3, 1913, § G (a). The 1916 Law taxed "Every corporation, joint-stock company or association, or insurance company organized in the United States, no matter how created or organized but not including partnerships." (Revenue Act of 1916, § 10 (a)). The 1918 Law taxes every corporation and defines the term "corporation" to include "associations, joint-stock companies, and insurance companies."

panies in the same category with corporations.[15] A joint-stock company organized pursuant to the New York Joint-Stock Association Law was held, under the 1909 Law, to be practically a "corporation," despite the absence of the important corporate attribute of limited liability, and was held taxable as such.[16] It was held under the 1913 Law that an association, formed as a partnership under the laws of Hawaii and having as its members a number of corporations, was not a corporation. In the association involved in this case there were no special partners nor was there limited liability. The partnership arrangement lacked the element of changeability of membership or transferability of shares, an element often used as a determining criterion as between ordinary partnerships and joint-stock companies. In a joint-stock company the members have no right to decide what new members shall be admitted to the firm; on the other hand, such a right is an inherent quality of the ordinary partnership.[17] By regulation issued under the 1918 Law, it is provided that the terms "joint-stock companies" and "associations" include associations, common-law trusts, or organizations by whatever name known which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders

(Revenue Act of 1918, § 1, 230.) It will be noted that the phrase "no matter how created or organized" used in both the 1913 and 1916 Laws is omitted from the definition of corporation contained in the 1918 Law. On the other hand, the phrase "joint-stock company or association" (between commas) has been changed to "associations, joint-stock companies." The purpose of this transposition is to separate the word "associations" from any limitation imposed by conjunction with the word "joint-stock" and to use it to cover organizations which cannot be included within the terms "corporations," "joint-stock companies," or "insurance companies." The phrase "no matter how created or organized" seems to have been aimed to include organizations not "organized *under the laws* of the United States or of any state * * *" which were held not liable to tax under the 1909 Law, in view of the language of that Act. See Crocker v. Malley, 249 U. S. 223; Eliot v. Freeman, 220 U. S. 178; T. D. 2418; Reg. 38 Rev., Art. 2, General Instructions 3; see also Chapter 44 on Capital Stock Tax.

15 See Spreckels Sugar Refining Co. v. McClain, 192 U. S. 397; Flint v. Stone Tracy Co., 220 U. S. 107.

16 Roberts v. Anderson, 226 Fed. 7.

17 Haiku Sugar Co. v. Johnstone, 249 Fed. 103; Reg. 45, Art. 1503.

on the basis of the capital stock which each holds, or where there is no capital stock, on the basis of the proportionate share or capital which each has, or has invested, in the business or property of the organization.[18]

"SYNDICATES" ARE NOT CORPORATIONS. Where a block of securities is purchased in joint account by several corporations, partnerships or individuals for the purpose of disposing of them to the public through the syndicate managers, the only obligation of the members of the syndicate being to take and pay for the portion of the securities not disposed of, such temporary combinations of business interests are neither corporations, joint-stock companies or associations, nor partnerships, within the meaning of the income tax law and the profits of the syndicate are not taxable in the hands of the syndicate. The several members pay the tax on their respective shares of the profit of the transaction.[19]

TRUSTS NOT TAXABLE AS ASSOCIATIONS. In a case arising under the 1913 Law a Maine corporation with eight shareholders had its mills in Massachusetts and owned outlying land. The Maine corporation conveyed to a Massachusetts corporation formed in 1912 seven mills and let to it an eighth that was in the process of construction, together with the outlying lands and tenements, on a long lease, receiving the stock of the Massachusetts corporation in return. The Maine corporation then transferred to the plaintiffs as trustees the fee of the property subject to the lease, left the Massachusetts stock in their hands, and was dissolved. By the declaration of trust the plaintiffs declared that they held the real estate and all other property at any time received by them thereunder, subject to the provisions thereof, "for the benefit of the *cestui que trusts* (who shall be trust beneficiaries only, without partnership, associate, or other relations whatever *inter sese*)" upon trust to convert the same into money and distribute the net proceeds to the persons then holding the trustees' receipt certificates—the time of distribution being left to the discretion of the trustees, but not to be postponed beyond the end of twenty years after the death of the specified persons then living. In the meantime the trustees were to have the powers of owners, were to distribute what they determined to be fairly distributable net

18 Reg. 45, Art. 1502; Reg. 33 Rev., Art. 58. See also Reg. 33, Art. 79.
19 Letter from Treasury Department dated February 25, 1914.

income according to the interests of the *cestuis que trust*, but could apply any funds in their hands for the repair or development of the property held by them, or the acquisition of other property, pending conversion and distribution. A consent of a majority in interest of the *cestuis que trust* was required for the filling of a vacancy among the trustees, for a modification of the terms of the trust, or for any increase over the stipulated fee of the trustees. In no other matter had the beneficiaries any control. The court held that (1) the declaration of trust was an ordinary real estate trust of the kind familiar in Massachusetts in spite of the fact that the trustees' receipt provided that the holder had no interest in any specific property and that it purported only to declare the holder entitled to a certain fraction of the net proceeds of the property when converted into cash "and meantime to income," and in spite of the fact that the trustees held (although not pursuant to the declaration of trust) stock of the Massachusetts corporation and collected dividends upon it; (2) the function of the trustees was not to manage the mills but simply to collect the rents and income from such property as might be in their hands, with a large discretion in the application of it, but with a recognition that the receipt holders were entitled to it, subject to the exercise of the powers confided to the trustees; (3) that the trust would not fall under any familiar conception of a joint-stock association, "whether formed under a statute or not"; (4) the trustees by themselves could not be a joint-stock association, and there was no ground for grouping the trustees and beneficiaries together; (5) the result was not affected by any technical analysis of the individual receipt holder's rights in the income received by the trustees; and (6) the statute failed to show a clear intent to subject the trust to tax as an association or the trustees or receipt holders to extra tax upon the dividends of the Massachusetts corporation.[20] In the case under the 1916 Law

[20] Crocker v. Malley, 249 U. S. 223, reversing 250 Fed. 817. The court said in part: "We do not see either that the result is affected by any technical analysis of the individual receipt holder's rights in the income received by the trustees. The description most in accord with what has been the practice would be that, as the receipts declare, the holders, until distribution of the capital, were entitled to the income of the fund subject to an unexercised power in the trustees in their reasonable discretion to divert it to the improvement of the capital. But even if it were said that the receipt holders were not entitled to the income as such until they got it, we do not discern how that

of a trust created to hold certain land and to dispose of the same and distribute the proceeds to the beneficiaries, the title stood in the names of the trustees who received and distributed moneys, and transacted all of the business connected with the management and control of the trust property. The pro-rata interests of the beneficiaries were represented by beneficial certificates issued to them by the trustees. These certificates could be transferred if the transferee executed and became a party to the original declaration of trust and articles of agreement. The purpose of the trust was to dispose of the land from time to time and pay the net proceeds over to the beneficiaries and the trustees had no power to carry on any other business. It was held that this trust partook of the character of an association and was subject to the tax as an entity.[21] This ruling would seem to be superseded by the case above referred to. The Treasury Department now treats the question whether the *cestuis que trust* have a voice in the conduct of the business as the decisive test. Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the *cestuis que trust* are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries.[22] If, however, the *cestuis*

would turn them into a joint-stock company. Moreover the receipt holders did get it and the question is what portion it was the duty of the trustees to withhold. We presume that the taxation of corporations and joint-stock companies upon dividends of corporations that themselves pay the income tax was for the purpose of discouraging combinations of the kind now in disfavor, by which a corporation holds controlling interests in other corporations which in their turn may control others, and so on, and in this way concentrates a power that is disapproved. There is nothing of that sort here. Upon the whole case we are of opinion that the statute fails to show a clear intent to subject the dividends on the Massachusetts corporation's stock to the extra tax imposed by G. (a)." (See also Reg. 45, Art. 1504.)

21 Letter from Treasury Department dated March 14, 1917.

22 See Chapter 6.

que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association.[23]

LIMITED PARTNERSHIPS AND PRIVATE BANKS. This subject is discussed in another chapter.[24] A private bank owned by an individual is not an "association."

Residence. A domestic corporation is one organized or created in the United States including only the states, the territories of Alaska and Hawaii and the District of Columbia.[25] Domestic corporations are considered to be residents of this country, wherever their property or their business is located and whether or not they do business within or without this country. A domestic corporation is taxable regardless of the fact that it may derive all of its income from sources outside of the United States,[26] but dividends on the stock and interest on the notes of domestic corporations which do no business and own no property in the United States, paid to non-resident aliens or corporations are not subject to tax.[27] Under the present law, domestic corporations may credit

[23] Reg. 45, Art. 1504.

[24] See Chapter 8, p. 107. Under the 1916 Law limited partnerships—that is, partnerships having one or more special partners who might share in the profits of the firm but whose liability for the debts of the company was limited to the amount of capital invested by such partner or partners—were first held broadly to be taxable as associations for purposes of the income, excess profits and capital stock tax. (Reg. 45, Art. 1506; T. D. 2711; Letter from Treasury Department dated May 4, 1918, I. T. S. 1918, ¶ 3355.) But this rule was later modified as indicated in Chapter 8.

[25] Revenue Act of 1918, § 1.

[26] This definition follows the American theory that a corporation cannot migrate but must remain a resident of the jurisdiction in which it is created. See Chapter 12, p. 186. In a case under the 1909 Law payment of the tax was refused, the corporation claiming that because its business was transacted in a foreign country and it had no assets in this country, its stockholders living in the foreign country and its income being spent and invested there, it was not liable for the tax assessed. The Treasury Department proposed to test the question but after the institution of suit the Company abandoned its position and made payment covering the tax and penalties, the action being thereupon discontinued. (T. D. 1863.)

[27] Reg. 45, Art. 92. This is a departure from the position heretofore taken by the Treasury Department. It seems, however, that the ruling applies to situations under former laws as well as under the present law. The ruling reads as stated in the text, but the Treasury Department has held in a par-

against the amount of tax which would be due on income derived from all sources the amount of any income and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein, or to any possession of the United States, provided they furnish satisfactory evidence showing the amount of income derived from sources within such foreign country or such possessions of the United States, as the case may be, and all other information necessary for the computation of such credit.[28]

CORPORATIONS DOING BUSINESS IN THE PHILIPPINES AND PORTO RICO. Under former income tax laws corporations doing business wholly in Porto Rico and the Philippines, even though incorporated in the United States, were held to be resident corporations of these possessions and were required to make return and pay the income tax to the collector of internal revenue having jurisdiction therein. If a corporation was resident in the United States, and was doing only a part of its business in Porto Rico and the Philippines, it was taxable only in the United States. A corporation organized under the laws of the United States (i. e. the federal laws) or under the local laws of these possessions and resident therein was required to pay the tax in the possession in which it was resident.[29] Under the present law every corporation "created or organized in Porto Rico or the Philippine Islands, or deriving income from sources therein," is taxable in those possessions in accordance with the provisions of the 1916 Law as amended. A corporation "created or organized outside Porto Rico or the Philippine Islands and deriving income from sources therein" is treated in those possessions as a foreign corporation. Thus, a corporation created or organized in the United States is a foreign corporation in the possessions of the United States, but it may credit the tax which would otherwise be payable to the United States on income derived from all sources, both within and without the United States, with the amount of tax which it has paid in Porto Rico or the Philippines, as the case may be, upon income derived from sources therein. This credit, like similar credits for all foreign taxes upon income derived from sources in for-

ticular case that interest on tax-free covenant bonds as well as interest on notes is not taxable under the same conditions.

28 Revenue Act of 1918, § 238 (a).

29 T. D. 2090.

eign countries, will only be allowed if the corporation furnishes satisfactory evidence showing (a) the amount of income derived from sources within the possessions and (b) all other information necessary for the computation of the tax.[30] A United States corporation which derives income from sources within Porto Rico, a Porto Rican corporation which derives income from sources within the United States, and a corporation of a foreign country which derives income both from sources within Porto Rico and from sources within the United States, are all taxed in both places. In the case of the United States corporation the income and excess profits taxes in the United States are credited with the amount of any income and excess-profits taxes paid in Porto Rico. In the case of the Porto Rican corporation there is no such credit. The corporation of the foreign country deriving income from both places is subject to no double taxation so far as the United States and Porto Rico are concerned. The same principles apply in the case of the Philippine Islands.[31]

Gross Income. Corporations are subject to tax on income received from all sources including gains, profits and income derived from trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of ownership or use of or interest in such property; and also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income from any source whatever, except income which is not to be included in gross income, as provided in the Revenue Act of 1918. The items not to be included in gross income of a corporation are: (a) property acquired by gift, bequest, devise or descent (but income from such property is taxable);[32] (b) interest upon (1) the obligations

30 Revenue Act of 1918, §§ 261 and 238.

31 Reg. 45, Art. 1133.

32 Prior to the enactment of the 1916 Law it was not clear that a corporation was exempt from tax on the value of property acquired by gift. Under the 1909 Law gifts to corporations were held to be taxable as income, although the law was silent in this respect. Under the 1913 Law it was held that the statutory exemption of gifts did not apply to corporations, since the 1913 Law provided for such exemption under a provision applicable to individuals only and made no mention of such exemption in the provisions applicable to corporations. The 1916 Law provided for the exemption of the value of gifts in a section applying with equal force to corporations and individuals. (Compare Revenue Act of 1916, § 4 and Revenue Act of 1913, ¶ B.)

of a State, Territory, or any political subdivision thereof, or the District of Columbia, or any possession of the United States; (2) securities issued under the provisions of the Federal Farm Loan Act; (3) the obligations of the United States issued prior to September 1, 1917, and if issued after such date, if and to the extent the acts authorizing the issue thereof exempt the interest from taxation to the corporation both under the income and the excess-profits taxes; (4) bonds issued by the War Finance Corporation, if and to the extent the acts authorizing the issue thereof exempt the interest from taxation to the corporation both under the income and the excess-profits taxes;[33] and (c) income derived from the operation of a public utility to be acquired, constructed, operated or maintained by a corporation pursuant to a contract made with a State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, in excess of the part thereof to which the corporation is entitled under such contract.[34] Gross income includes items subject to the excess-profits tax as well as income tax, but for the purpose of the latter these items are credited against the net income.[35] Where a corporation is engaged in carrying on more than one class of business, the gross income derived from the different classes is ascertained according to the rules applicable thereto and the gross income of all the classes of business in which the corporation is engaged is taken to be the gross income of the corporation. Thus, the gross income of manufacturing companies consists of the total sales of manufactured goods during the year, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year; and mercantile companies proceed similarly in determining their gross income by inventory, adding in each case the income from all other sources.[36] The general provisions as to income applicable both to corporations and

[33] Although exempt bond interest is not included in gross income, it should be noted that every corporation owning any obligations, securities or bonds bonds which are exempt must submit a statement showing the number and amount thereof and the interest received therefrom in such form and with such information as the Commissioner may require.

[34] Revenue Act of 1918, §§ 233 and 213.

[35] Revenue Act of 1918, § 236.

[36] Reg. 33 Rev., Arts. 91 and 92. See also Reg. 33, Arts. 104 and 105.

individuals are discussed in the succeeding chapters on income [37] and only the special provisions applicable to corporations are referred to in this chapter. Not all receipts by a corporation are income, as is indicated in the following paragraphs.

SALE OF CAPITAL STOCK. The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than the par value of the stock issued, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. Likewise, if the stock is sold at a discount, the amount of the discount is not a loss deductible from gross income. If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock.[38]

INCOME FROM LEASED PROPERTY. Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance or other fixed charges, such payments are to be considered rental payments and are to be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest

[37] See Chapters 14 et seq.

[38] Reg. 45, Art. 542; Reg. 33 Rev., Arts. 98 and 99; T. D. 2090.

and dividend payments received as from the lessor and as such must be accounted for in their returns.[39]

CONTRIBUTIONS BY STOCKHOLDERS. Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the company.[40] If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.[41]

INTEREST UPON LIBERTY BONDS. Income of a corporation as such is taxable to the corporation and not to the stockholders.

[39] Reg. 45, Art. 546; Reg. 33 Rev., Arts. 102, 104, 125, 208; Reg. 33, Art. 82; T. D. 2090. The lessee, in making these payments direct to the bond holders and the stockholders, does so as the agent of the lessor. Where under the terms of a lease a lessee agreed to pay the interest upon and discharge the bonds issued by the lessor, to maintain the right of way and buildings, and to pay direct to each stockholder of the lessor dividends at the rate of eight per centum per annum, it was held that the amounts paid to the creditors and stockholders of the lessor were rents or compensation to the lessor for the use and occupation of its property and constituted net income to it. It was held to be immaterial that the lessor was not possessed of money or other cash revenues with which to pay the tax. The lessor could not exonerate itself from liability for the tax subsequently imposed under a law thereafter enacted by making a lease of its property which provided for the payment of all its surplus revenues direct to its stockholders. (Rensselaer & Saratoga Railroad Co. v. Irwin, 249 Fed. 726, writ of certiorari denied, 246 U. S. 671. See Northern Co. v. Lowe, 250 Fed. 856.) The notion that a corporation is an artificial entity distinct from the members who compose it is a fiction of the law which the courts recognize for some purposes and disregard for others. Thus, the fact that a lessee corporation pays the rent not to the lessor corporation but to its stockholders and bondholders, cannot prevent the lessor corporation from being taxable. (Anderson v. Morris & Essex Railroad Co., 216 Fed. 83.)

[40] Reg. 45, Art. 543; letter from Treasury Department dated February 21, 1916; I. T. S., 1918, ¶ 1291.

[41] Reg. 45, Art. 51. See Oregon-Washington Co. v. U. S., 251 Fed. 211.

The corporation, and not the stockholders, is regarded as the owner of Liberty Bonds held by the corporation and is entitled to exemption on account of such ownership. Thus, when bonds of the Fourth Liberty Loan are subscribed for by the corporation, it, and not the stockholders, is the original subscriber and is entitled to the collateral exemption of interest on bonds of previous issues on account of such original subscription.[42]

Deductions in Computing Net Income. The statute specifies particularly the deductions which may be made by a corporation from its gross income in computing its net income. In general, the deductions from gross income allowed corporations are the same as allowed individuals, except that corporations may deduct dividends received from other corporations subject to the tax and may not deduct charitable contributions.[43] Certain items are also expressly declared by the Revenue Act of 1918 not to be deductible in the case of corporations as well as individuals. These items are discussed in another chapter.[44] These deductions are discussed generally in the several chapters relating respectively thereto.[45] In this chapter reference is made only to those provisions having special application to corporations.

ORDINARY AND NECESSARY EXPENSES. A corporation is allowed to deduct all the ordinary and necessary expenses paid or incurred[46] during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.[47] It will be noted that the expenses permitted by this provision of the law are only the *ordinary* and *necessary* expenses. Extraordinary expenses are not deductible under this head, al-

[42] T. D. 2742. See Chapter 14.

[43] Reg. 45, Art. 561.

[44] Revenue Act of 1918, §§ 215 and 235; Reg. 45, Art. 581, See Chapter 21.

[45] See Chapters 21—30.

[46] The terms "paid or incurred" or "paid or accrued" are construed according to the method of accounting upon which net income is computed under § 212 of the Statute. (Revenue Act of 1918, § 200.)

[47] Revenue Act of 1918, § 234 (a) 1.

though they may be deductions recognized in accounting practice as a proper charge against the income for the year.

SALE OF CAPITAL ASSETS. Where property is acquired and later sold for a higher price, the gain on the sale is income. If, however, the property was acquired before March 1, 1913, only such portion of the gain as accrued subsequently to February 28, 1913, is taxable. Where, then, a corporation sells its capital assets in whole or in part, it should include in its gross income for the year in which the sale was made the amount of the excess of the sales price over the fair market value of such assets as of March 1, 1913, if acquired prior to that date, or over their cost if acquired subsequently to that date. In every case, however, in ascertaining the gain, the cost of the assets, or the fair market value as of March 1, 1913, of the assets acquired prior thereto, should first be reduced by the amount of any charges for depreciation, depletion and other losses which have been or should have been made. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the purchase price. If the sale is made for stock of another corporation the rules relating to income from exchange of property will apply.[48]

ORGANIZATION EXPENSES. Organization expenses of corporations such as attorneys' and accountants' fees together with fees paid to state authorities prior to or coincident with the securing of a charter and the incorporation of a company constitute a capital investment, such assets being offset by the asset value of the corporate franchise, an intangible asset of a somewhat permanent character and in many instances of substantial value. It is held that such expenses constitute investments of capital and are not ordinary and necessary expenses, which are the only "expenses" authorized by the law to be deducted.[49]

EXPENSES INCURRED IN SALE OF CAPITAL STOCK. Expenses incidental to or connected with the selling of the capital stock (common or preferred) of a corporation for the purpose of raising capital to be invested by it in property to be employed in the business of the corporation are not an allowable deduction from

48 Reg. 45, Arts. 545, 563. See Chapter 17.

49 Reg. 45, Art. 582; T. D. 2490. This ruling is not in accordance with accounting practice, which recognizes the propriety of charging off organization expenses against income over a period of four or five years.

gross income, for the reason that such expenses are incurred in a capital transaction; that is, the raising of capital to be invested or employed in the business. Such expense, like the discount at which the shares of stock may be sold, has the effect only of reducing the available capital of the corporation and cannot be used to reduce the income from operations; that is to say, any expense incident to the bringing of capital into the company, whether it be a new or a going concern, cannot be recouped out of or charged against the operating income. It is a capital loss or expense properly chargeable against the proceeds of the sale of the stock and reduces the capital rather than the earnings of the company.[50]

HOLDING COMPANY GUARANTEEING DIVIDENDS OF SUBSIDIARY. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.[51]

INTEREST. With one exception the limitations[52] contained in the 1916 Law upon the deduction of interest by corporations are not imposed by the Revenue Act of 1918 and, corporations, like individuals, may now deduct all interest paid within the taxable year on their indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation for income tax purposes as income to the corporation.[53] Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at net income. In the case of banks and loan or trust companies interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued

50 Reg. 45, Art. 563; Reg. 33 Rev., Art. 145.

51 Reg. 45, Art. 582.

52 See the appendix for a statement of the rules relating to deduction of interest under the 1916 Law.

53 Revenue Act of 1918, § 234 (a) 2.

by such bank or loan or trust company may be deducted from gross income.[54]

TAXES. Corporations, like individuals, may deduct taxes paid or accrued,[55] within the taxable year imposed (a) by the authority of the United States except income, war-profits and excess-profits taxes, (b) by the authority of any possessions of the United States except income, war-profits and excess-profits taxes, (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, or (d) by the authority of any foreign country except income, war-profits and excess-profits taxes.[56] Except as stated in the following paragraph, the same rules apply to the deduction of taxes by corporations and individuals and are discussed elsewhere.[57]

INTEREST ON TAX-FREE BONDS. Where a corporation has issued bonds or other indebtedness with a guarantee that the interest thereon shall be paid without deduction for any tax which the corporation may be called upon to pay or withhold under the laws of the United States or of any State or jurisdiction, no deduction for the payment of the income tax or any other federal tax paid pursuant to the contract or provision contained in such bonds is permitted to the corporation under the heading of taxes or interest or on any ground. In the case, however, of corporate bonds or obligations containing an appropriate "tax-free covenant" clause, the corporation paying a State tax or any other than a federal tax for some one else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[58]

LOSSES. Corporations are permitted to deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise.[59] The rules pertaining to losses in inventory and from rebates and net losses apply similarly to individuals and corporations, and are discussed elsewhere in this book.[60]

54 Reg. 45, Art. 564.

55 See note 46.

56 Corporations are entitled to a credit against their tax for income, war-profits and excess-profits taxes, imposed by authority of any foreign country or any possession of the United States. (Revenue Act of 1918, § 238.)

57 Reg. 45, Art. 565. See Chapter 24.

58 Revenue Act of 1918, § 234 (a) 3; Reg. 45, Art. 565.

59 Revenue Act of 1918, § 234 (a) 4.

60 See Chapter 25.

One ruling on losses, having application only to corporations, is given below.

REDEMPTION OF PREFERRED STOCK. Where a corporation issued preferred stock at par, redeemable at 110, the difference appearing on the books of the corporation as a reduction of undivided profits, the transaction has been held to be a capital transaction in which there could be no gain or loss to the corporation, and, therefore, the difference between the selling price of the stock and the price at which it was redeemed could not be deducted as a loss.[61]

DIVIDENDS ON STOCK OF OTHER CORPORATIONS. Corporations may now deduct all amounts received as dividends from a corporation taxable upon its net income and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed.[62] Dividends paid by foreign corporations receiving no income from sources within the United States may not be deducted.[63]

CONTRIBUTIONS TO CHARITIES. Corporations are not entitled to deduct from their gross income for the purpose of the income tax the amount of contributions made to religious, charitable, scientific or educational corporations or associations, even though such contributions are made to the Red Cross or other war activities.[64]

61 Letter from Treasury Department dated April 11, 1917; I. T. S. 1919, ¶ 2083. The ruling is different as to the redemption of bonds sold at a discount. See Chapter 25.

62 Revenue Act of 1918, § 234 (a) 6. Under the 1913 Law corporations were not permitted to deduct the amount received as dividends from other corporations subject to the income tax. This was likewise true under the 1916 Law. For the purpose of the 1917 Law, dividends on the stock of such other corporations as were taxable thereunder on their net income might be deducted. Thus, in 1917 a corporation might not deduct dividends in computing the 2% tax imposed by the 1916 Law, but might do so in computing the 4% tax imposed by the 1917 Law.

63 See Chapter 19.

64 T. D. 2847 as amended May 24, 1919. This Treasury Decision was founded on an opinion of the Attorney General dated May 19, 1919, which held that Red Cross donations were not deductible as expense, and which was also founded on a consideration of the legislative history of the Revenue Act of 1918. (See Congressional Record for September 17, 1918, in which it appears that an amendment to the effect that corporations might deduct charitable

Credits Against Net Income. In addition to the deductions which corporations are permitted in computing their net income, corporations are allowed certain credits against net income. Credits differ from deductions in the case of corporations in that deductions reduce the net income for the purpose of all taxes, while credits reduce the net income for the purpose of the income tax and not for the purpose of the excess-profits tax. The credits are discussed in the following paragraphs.

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. The amount of interest received by a corporation upon obligations of the United States issued prior to September 1, 1917, is exempt from all taxation, and is excluded from the gross income of the corporation. The amount of interest upon obligations of the United States issued after September 1, 1917, and upon bonds issued by the War Finance Corporation is exempt from taxation only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and is excluded from gross income only if and to the extent it is wholly exempt from both income and war-profits and excess-profits taxation. Corporations are allowed a credit against net income for the purpose of the income tax of any amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[65]

AMOUNT OF WAR-PROFITS AND EXCESS-PROFITS TAX. Corporations are also allowed a credit for purposes of the income tax, of the amount of the war-profits and excess-profits tax assessed or to be assessed for the same taxable year.[66] In the case of a corporation making return for a fiscal year beginning in 1918 and ending in 1919, certain special rules apply, which are set forth elsewhere in this book.[67]

SPECIFIC EXEMPTION. Domestic corporations are permitted a credit for purposes of the income tax of the sum of $2,000 as a specific exemption.[68]

and other contributions and gifts in the same manner as individuals was defeated.)

65 Revenue Act of 1918, §§ 236 (a), 233, 213 (a) 4; Reg. 45, Art. 591.

66 Revenue Act of 1918, § 236 (b); Reg. 45, Art. 591.

67 See Chapter 24.

68 Revenue Act of 1918, § 236 (c); Reg. 45, Art. 591. The 1916 Law and the 1913 Law contained no similar provision.

Credits Against Tax. Domestic corporations may credit against the amount of tax which would be due on income derived from all sources the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein or to any possession of the United States.[69]

Receivers for Corporations. The Revenue Act of 1918 provides that in cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. This is true notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court. Any tax due on the basis of such returns made by receivers, trustees or assignees is collected in the same manner as if collected from the corporations of whose business or property they have custody or control.[70] Receivers of corporations are not fiduciaries within the meaning of the law and are not governed by the rules applicable to receivers for individuals.[71] The receiver of a corporation stands in the same position as the officers of a solvent corporation and upon him devolve all the duties of such officers as to the making of returns and payment of tax. The fact that the business and property of the corporation are temporarily in the hands of a receiver does not alter the fact that the corporation is the beneficiary of the income arising and accruing. If there is net income in excess of credits, it is taxable, and the custodian of such income is liable for the tax assessable thereon.[72] A

69 Revenue Act of 1918, § 238. See Chapter 32.

70 Revenue Act of 1918, § 239.

71 Reg. 45, Art. 424. This is true in view of the express provision of § 239 of the Revenue Act of 1918, notwithstanding the definition of "person" and "fiduciary" contained in § 200. See Chapter 6.

72 Under the 1913 Law, as well as under the 1909 Law, there was no express provision in the statute taxing corporations in the hands of receivers. Several cases under the 1909 Law held that that act did not impose a tax on such corporations or any duties on the receivers thereof. (See Pennsylvania Steel Co. v. New York City Railways Co., 193 Fed. 286; 198 Fed. 774, affirmed U. S. v. Whitridge, 231 U. S. 144.) The 1909 Law was a tax on corporations doing business and it was held in several cases that a corporation in the

receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.[73]

INCOME TAXABLE IN HANDS OF TRUSTEE IN BANKRUPTCY. It has been held under the 1916 Law that the only income taxable in the hands of a trustee in bankruptcy is the income earned by the trustee while operating the business of a bankrupt corporation. Thus, funds representing the result of a compromise made by the trustee with a foreign corporation of a claim for the non-payment of salaries and commissions by the foreign corporation to the bankrupt corporation as its agents between the years 1910 and 1914 have been held to be exempt from tax in the hands of the trustee in bankruptcy.[74]

Fiscal Year. A corporation is required to make returns and pay the tax on the basis of its annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping its books, unless (a) no such method of accounting has been employed, or (b) the method employed does not clearly reflect income. In case of (a) and (b) the computation of net income is made on such basis and in such manner as in the opinion of the Commissioner does clearly reflect income. If the corporation's annual accounting period is other than a fiscal year, or if the corporation has no annual accounting period, or does not keep books, its net income is computed on the basis of the calendar year. In the event of any change of accounting period from fiscal year to calendar year, or vice versa, or from one fiscal year to another,

hands of receivers was not one doing business within the meaning of those words as used in that act. Only one decision seems to have been rendered under the 1913 Law and in that case it was held that receivers were not subject to the income tax where the court took possession of the property of an insolvent railroad company and operated the railroad. The funds in the hands of the receivers, represented by the net proceeds in conducting the operation of the road, over and above the authorized expenditure paid out by them, were held not to be subject to the tax as "net earnings." (Equitable Trust Co. v. Western Pac. Ry. Co., 236 Fed. 813, affirmed Scott v. Western Pac. Ry. Co., 246 Fed. 545.) The question was no longer left open under the express provisions of the 1916 Law.

[73] Reg. 45, Art. 622.

[74] In re Heller Hirsh & Co., 258 Fed. 208.

net income is computed on the basis of such new accounting period, subject to the rules outlined in a later chapter.[75] Reporting upon the basis of a fiscal year was formerly a privilege accorded to corporations and partnerships only. It is now a requirement if the annual accounting period of the corporation is a fiscal year. This subject is more fully treated in another chapter.[76]

Returns. The duty to make a return depends upon corporate existence and not upon the receipt of income. Every corporation not expressly exempt is required to make a return regardless of the amount of its net income.[77] Copies of the prescribed return forms will be furnished corporations by collectors. Failure on the part of any corporation liable to tax to receive a prescribed blank form will not, however, excuse it from making the return. Corporations not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified and filed with the collector on or before the due date. Each corporation should carefully prepare its return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a corporation disclosing its gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the corporation from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form, or an extension of time is obtained.[78]

WHEN FILED. Returns of income must be made on or before March fifteenth or the fifteenth day of the third month following

[75] Revenue Act of 1918, §§ 212 and 232; Reg. 45, Art. 25.

[76] See Chapter 34 for the rules with respect to the taxation of corporations with fiscal year ending in 1919.

[77] Reg. 45, Art. 621.

[78] Reg. 45, Arts. 621 and 407; Reg. 33 Rev., Art. 203; Reg. 33, Art. 80. Under the 1909 Law it was held that corporations of all kinds specified in the Act as subject to the tax were bound to file returns though their net profits were not sufficient to *render them liable to the tax* (U. S. v. Military Construction Co., 204 Fed. 153), and that the duty to make returns was not limited to those the net profits of which were sufficient to *render them liable to the payment of the tax.* (U. S. v. Acorn Roofing Co., 204 Fed. 157.)

the close of the fiscal year for which the return is required to be made.[79]

EXTENSION OF TIME. A corporation desiring an extension of time within which to file its return should submit to the collector before the time for filing the return a tentative return and estimate on Form 1031 T, accompanied by a remittance of not less than one-fourth of the estimated amount of income and excess-profits taxes for the taxable year. In such a case the collector may grant a reasonable extension of time for filing the complete return, not to exceed thirty days from the date on which the return was originally due.[80]

WHERE FILED. Corporate returns are filed with the collector of the district in which is located the principal place of business or principal office or agency of the corporation. If a domestic corporation keeps its books of account and other data in a foreign country and has no principal place of business or principal office in this country, the return should be made to the collector in the district in which the corporation has its principal agency in this country.[81] If it has no such agency or branch office in this country, the return should be made to the collector of the district in which is located its statutory office; that is, the office required to be maintained in the State of incorporation in accordance with the statutes of that State.[82] It is to be noted that the return is not to be filed in the district in which is located the statutory office, unless the corporation has no principal place of business or principal office or agency from which the return can be filed. The purpose of designating the principal business office is for the convenience of the Treasury Department in examining the books of the corporation and verifying the return. Since the statute now expressly designates the principal place of business or principal office or agency, the filing of a return from another office may not be considered a proper filing.[83]

[79] Revenue Act of 1918, §§ 227 (a), 241 (a).

[80] See Chapter 34.

[81] Revenue Act of 1918, § 241 (b).

[82] T. D. 2137.

[83] The 1916 Law required corporate returns to be made "to the collector of the district in which is located the principal office of the corporation, company or association, where are kept its books of account and other data from which the return is prepared." The 1913 Law was less explicit and might

BY WHOM FILED. Responsibility for filing corporate returns rests upon the principal officers of the corporation, although there is no penalty on such officers personally for failure to file returns. The only personal penalty on officers is for wilfully refusing to make the return, pay the tax, supply information required, or in any manner attempting to defeat or evade the tax.[84]

HOW SIGNED AND SWORN TO. The return is required to be sworn to by the president, vice-president or other principal officer of the corporation and by the treasurer or assistant treasurer, and must be verified under the oath of such officers, except in the cases where the return is filed by a receiver, trustee, or assignee, or directors in the case of insolvency, in which cases the affidavit on the return should be changed in accordance with the facts.[85]

CORPORATIONS FORMED DURING THE YEAR. A corporation organized during the year is required to make a return covering that portion of the year during which it was in existence.[86] The fact that a new corporation organized in the year has transacted no business does not excuse it from making a return.[87] Corporations which have applied for but not received charters, or corporations which have received charters but have not perfected their organizations, transacted any business and had any income whatever from any source, may upon the presentation of these facts to the local collector be relieved from the necessity of making returns so long as they remain in this unorganized condition. In the absence of a proper showing to the collector, such a corporation will be required to make a return.[88] When a distinct new corporation is organized to take over the property of an old corporation, both corporations will be required to make returns covering the periods of the year during which they were each respectively in charge of the business, or file a consolidated return.[89]

have been held to justify the filing of corporate returns from some other office, but the 1918 Law as well as the 1916 Law is open to no such construction.

[84] Revenue Act of 1918, § 253.

[85] See Chapter 34.

[86] Reg. 33, Art. 84; Reg. 45, Art. 621.

[87] T. D. 2090. Reg. 45, Art. 621.

[88] T. D. 2152. Reg. 45, Art. 621.

[89] Reg. 33 Rev., Art. 206; T. D. 2137.

CORPORATIONS MERGING DURING THE YEAR. In case of a merger or consolidation of two or more corporations during the year, it was held under the 1909 Law that each corporation was required to make a return of income received during the year prior to the date of merger and consolidation,[90] but under the present law it seems in such case a consolidated return would account for all the income of the year.

CHANGE OF NAME. A mere change in name does not constitute a new corporation. If the business was continuous throughout the year, no change in management or operation other than the change in name having occurred, the return should be made covering the business transacted throughout the year, such return to be made by the corporation in the name which it bears at the end of the year, with a notation on the return to the effect that the name had been changed, giving both the old and the new names.[91]

CORPORATIONS LIQUIDATING DURING THE YEAR. A corporation going into liquidation during any taxable year may upon the completion of such liquidation prepare a "final return" covering its income during the fractional part of the year during which it was engaged in business and may immediately file such return with the local collector.[92] Under the present law it seems to be within the power of the Commissioner to declare the taxable period of a corporation terminated at the end of the calendar month preceding the month in which it is dissolved and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment

[90] T. D. 1675.

[91] Reg. 33 Rev., Art. 206; T. D. 2137.

[92] Reg. 45, Art. 651, Reg. 33 Rev., Art. 205; Reg. 33, Art. 85; T. D. 2209; T. D. 2090. This return should be filed by the directors or other persons in charge of the winding up of the corporation. Under the Corporation Act of New Jersey, (P. L. 1896, p. 295) which provides that corporations, however dissolved, are "continued bodies corporate for the purpose of prosecuting and defending suits by or against them and of enabling them to settle and close their affairs," and constitutes the directors trustees to settle the business, the officers of a corporation which had been dissolved after becoming subject to the tax on its income of the preceding year, who were also its directors, were held to have authority and to be under the duty of making the return of such business required by the 1909 Law. (U. S. v. General Inspection & Loading Co., 192 Fed. 223; 204 Fed. 657.)

thereof.[93] This remedy is more fully discussed elsewhere in this book.[94] Where a corporation, by affidavit or otherwise, has clearly established the fact and satisfied the collector that it is defunct, dissolved or obsolete and is no longer carrying on business and has no property or income, returns will not be required after such condition has been clearly established. Only one showing of this character is required, unless it appears later that the corporation has income within the meaning of the law.[95]

RETURNS FOR FRACTIONAL PART OF YEAR. In the case of a corporation making its first return of income on the basis of a fiscal year and in the case of a corporation changing its accounting period, whether from calendar year to fiscal year, from fiscal year to calendar year, or from one fiscal year to another fiscal year, a separate return for a fractional part of a year is required. In such a case the credit of $2,000 against net income allowed a domestic corporation must be reduced to such proportion of the full credit as the number of months in the period for which the return is made bears to twelve months.[96]

Consolidated Returns. Affiliated corporations are required to file consolidated returns on Form 1120. The consolidated return should be filed by the parent or principal reporting corporation in the office of the collector of the district in which it has its principal office. Each of the other affiliated corporations should file in the office of the collector of its district Form 1122, along with the several schedules indicated thereon. The parent or principal corporation filing a consolidated return should include in such return a statement specifically setting forth (a) the name and address of each of the subsidiary or affiliated corporations included in such return, (b) the par value of the total outstanding capital stock of each of such corporations at the beginning of the taxable year, (c) the par value of such capital stock held by the parent corporation or by the same interests at the beginning of the taxable year, (d) in the case of affiliated corporations owned by the same interests, a list of the individuals or partnerships constituting such interests, with the percentage of the total outstanding stock of each affiliated corporation held by each of such individ-

93 Revenue Act of 1918, 250 (g).
94 See Chapter 35.
95 T. D. 2137.
96 Reg. 45, Art. 626.

uals or partnerships during all of the taxable year, and (e) a schedule showing the proportionate amount of the total tax which it is agreed among them is to be assessed upon each affiliated corporation.[97] The Treasury Department greatly prefers that the parent or principal reporting corporation take up and pay the entire tax, making any desired adjustments thereof by charging the affiliated corporations through their own records. The amount reported by the subsidiary on Form 1122 as apportioned to it will be used as the basis of assessment and payment. If the subsidiaries have reported an apportionment in this manner, but the parent corporation has paid the tax installments on account of such subsidiaries, an amended Form 1122 should be filed showing "none" in answer to the question as to the amount of tax apportioned to it. If the last condition obtains, but the taxpayer insists upon apportionment the collector of the subsidiary's district will request abatement of such portion of the subsidiary's tax as may have been previously paid by the parent corporation in another district. As a basis for such advice, the latter collector will secure from the parent corporation a schedule showing apportionment of the total tax and installments to the respective affiliated corporations. If a subsidiary has filed a tentative return and paid an installment of the tax, it should be assessed the amount shown on Form 1122, and will pay future installments as they fall due.[98] Foreign corporations and personal service corporations need not file consolidated returns.[99]

97 Reg. 45, Art. 632.

98 Mimeograph letter to collectors, I. T.—Mim. 2221 dated August 8, 1919; I. T. S. 1919, Par. 3570.

99 Revenue Act of 1918, § 240. The English Finance Act of 1915 provided for the consolidated assessment of the excess profits duty in the case of affiliated companies carrying on the same trade or business. Before the regulations under the 1917 American Law were issued the American Institute of Accountants advocated the assessment of federal corporate taxes upon the basis of consolidated returns in a brief of which the following is an extract: "If the rule which we advocate (consolidated returns) be adopted the tax will be based on the real facts and determined by the relation between true income and the true investment of the group of companies as a whole; and the latter course (consolidated returns) would impose no additional burdens on anyone, since it is the course followed for all practical purposes by the corporations themselves and recognized by bankers, economists and accountants as the only course which reveals the true situation." (Journal of Accountancy, January, 1919.)

Affiliated Corporations. The provision [100] of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation reresults which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group.[101]

100 Revenue Act of 1918, § 240.

101 Reg. 45, Art. 631. The fact that one corporation held the entire capital stock of another and that the two were component parts of one business unit or system did not ordinarily, under the 1916 Law, destroy the separate entities of the two corporations. As a general rule corporations as such were subject to the tax, not the business organizations of which the corporations might be a part. Every corporation was considered to be a distinct entity regardless of its relation to any other corporation. Where a parent corporation owned all or practically all of the stock of subsidiary companies, each was required to make a return accounting in detail for their separate gross incomes and deductions, and each was generally required to pay the tax on the net earnings shown by such return. The parent company was not permitted to report the gross income of all the subsidiaries and deduct therefrom the gross expenses. (T. D. 2137; T. D. 2090.) The net earnings of the subsidiary companies turned over to the parent company were to be treated as dividends, notwithstanding the earnings out of which the dividends were paid were also subject to tax, as against the subsidiary companies. In U. S. v. Nipissing Mines Co., 206 Fed. 431, 234 U. S. 765, decided under the 1909 Law,

WHEN CORPORATIONS ARE AFFILIATED. Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" cannot be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of the outstanding voting

it was held that although the affairs of the holding and operating company were closely connected and they had officers in common, the distinct corporate existence of each should not be ignored and the holding company should not be treated as being engaged in the business of the operating company. It was held in an early ruling that the fact that a corporation had a number of subsidiaries only for the purpose of protecting trade brands, trade marks and trade names was immaterial; that the liability to make separate returns attached to each subsidiary company by reason of the fact that it was a separate and distinct entity. If such subsidiary had no net income or earnings and no expense of operations, and if the earnings accrued direct to the parent company, which also paid direct the operating expenses of the subsidiaries, those facts should be set out in the return of the subsidiary, but they did not operate to release the subsidiary from liability to make a return. (T. D. 2161.) If subsidiary corporations existed in name only, or were mere agents or integral parts of the parent corporation and as such, transacted no business and had no income of and for their own account, and incurred no expenses, all business being transacted, all income being received and all expenses being paid directly by the parent company, no separate accounts being kept by or for such subsidiaries, it was considered that such subsidiary concerns had no taxable income. In such cases, however, such subsidiary corporations were required to make returns and indorse thereon a statement to the effect that the corporation making the return was a subsidiary or integral part of the parent company (naming it) and that, for its own account, it had no income from any source whatever, that it made no disbursements, and that all the business done in its name was done for the account of and was the business of the parent corporation, and would be accounted for in the return of such parent corporation. This ruling (Reg. 33, Rev., Art. 208) was not intended to cover those subsidiary corporations which actually transacted business in their own names, received income for their own account, which incurred and paid expenses incident to the production of such income, which kept separate books of account, and which, as separate entities, exercised all the powers and functions authorized by their charters. Corporations of this character were required to pay the income tax on the net income received by them from all sources, regardless of the fact that such net income was paid or turned over to a parent or holding company, by whom it was also returned for the purpose of the tax.

capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned in each subsidiary or affiliated corporation and the percentage of such stock owned to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return. The words "the same interests" will be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned by two or more individuals or by two or more partnerships, a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.[102]

102 Reg. 45, Art. 633. Where substantially all of the stock of two or more corporations is held by the same interests, such holdings must be in substantially the same proportions in order to require a consolidated return. In the case of two corporations, one owning and operating property in the Hawaiian Islands, the other owning and leasing various pieces of property in California, the stock of the California corporation was held by the members of one family —four male members of the family, each owning five-twenty-fourths, and a sister one-sixth of the entire stock; and the stock of the Hawaiian Corporation was held by the same family principally, with the exception that one-sixth of the stock was held by each of the four male members aforementioned, one-sixth by the sister aforementioned, and one-sixth by the husband of a deceased sister to the other stockholders. Although the affairs and operations of the two corporations were always actively conducted by and in the control of the male members of the family, and although the two corporations were in purpose and effect only one enterprise, the Treasury Department has ruled that the holdings of the two companies were not so substantially in the same proportions as to require a consolidated return, and that these two corporations should file separate returns. (Letter from Treasury Department dated April 11, 1919, I. T. S. 1919, ¶ 3295.) Under the Act of October 3, 1917, two or more corporations were deemed to be affiliated "(1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock (95% or more of such stock, T. D. 2662)

CHANGE IN OWNERSHIP DURING TAXABLE YEAR. When one corporation owns substantially all the stock of another corporation at the beginning of any taxable year, but during the taxable year sells all or a majority of such stock to outside interests not affiliated with it, or when one corporation during any taxable years acquires substantially all the capital stock of another corporation with which it was not previously affiliated, a full disclosure of the circumstances of such changes in ownership must be submitted to the Commissioner. In accordance with the peculiar circumstances in each casé the Commissioner may require separate or consolidated returns to be filed, to the end that the tax may be equitably assessed.[163]

of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus affecting an artificial distribution of profits; or (b) in any way so arranges its financial relationships with another corporation as to assign to it a disproportionate share of net income or invested capital.'' Two or more corporations were not ''affiliated'' merely because all or substantially all of the stock therein was owned by the same corporation, individual or partnership; they were required also to be engaged in the same or a closely related business. For purposes of regulation by Public Service Commissions or similar authorities the identity of public service corporations, when not grouped into one operating unit, were required to be maintained, even though they were owned by the same corporation; and under such regulation the accounts of such public service corporations were deemed to reflect the true invested capital and income of each operating unit. Accordingly, railroads, gas, electric, water and other public service corporations when operated independently and not physically connected or merged—particularly when situated in different jurisdictions and subject to regulation by public service commissions—were not required or permitted without special permission obtained in advance, to make a consolidated return. (T. D. 2662.) This ruling, however, does not apply under the Revenue Act of 1918. In other words, public service corporations which otherwise would be deemed to be affiliated corporations are *not* to be taken out of that class because of the fact that they are public service corporations and otherwise meet the conditions above outlined. (Letter from Treasury Department dated April 17, 1919; I. T. S. 1919, ¶ 3306.) When, however, a railroad or other public utility was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations, and such affiliated corporations were required to file a consolidated return, the return of such railroad or other public utility was included therein. (T. D. 2662.)

[163] Reg. 45, Art. 634.

CORPORATION DERIVING CHIEF INCOME FROM GOVERNMENT CONTRACTS. In the case of any affiliated corporation organized after August 1, 1914, and not a successor to a then existing business, 50 per cent or more of whose gross income consists of gains, profits, commissions, or other income derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the net income and invested capital of such corporation will be taken out of the consolidated net income and invested capital of the group of affiliated corporations and the corporation so segregated will be separately assessed on the basis of its own invested capital and net income, the remainder of such affiliated group being assessed on the basis of the remaining consolidated invested capital and net income.[104]

DOMESTIC CORPORATION AFFILIATED WITH FOREIGN CORPORATION. A domestic corporation which owns a majority of the stock of a foreign corporation will not be permitted or required to include the net income or invested capital of such foreign corporation in a consolidated return,[105] but a domestic corporation which owns a majority of the voting stock of a foreign corporation is entitled to credit its income, war-profits and excess-profits taxes with any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the tax-

104 Reg. 45, Art. 635. Government contracts may include (*a*) a contract with the United States, (*b*) a contract with an agency of the United States, (*c*) a contract with an agency of such agency, and (*d*) a subcontract with a contractor under any such contract; provided in every case the contract or subcontract is for the benefit of the United States. Unenforceable contracts subsequently ratified are treated as though made when originally executed. The Commissioner may require any contractor to file with him copies of his Government contracts entered into on or after April 6, 1917, and shall have access to the information in the possession of the Government relating to such contracts. The realization by a corporation of income from a Government contract may affect its status under the consolidated returns provision and the amount of its war profits and excess-profits tax. The agreements for the operation of transportation systems while under Federal control and for the just compensation of their owners made pursuant to the act of March 21, 1918, are not Government contracts. (Reg. 45, Art. 1510.)

105 Reg. 45, Art. 636. Where a New Jersey corporation owned all of the outstanding stock in a foreign corporation which in turn owned all of the outstanding stock in a New York corporation, the Treasury Department required the domestic corporations above mentioned to file a consolidated return, excluding the foreign corporation. (Letter from Treasury Department dated April 23, 1919; I. T. S. 1919 ¶ 3315.)

able year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no such case may the amount of the credit for such taxes exceed the amount of such dividends received by such domestic corporation during the taxable year.[106]

Consolidated Net Income of Affiliated Corporations. Subject to the provisions governing the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions, the consolidated taxable net income will be the combined net income of the several corporations consolidated except that the net income of corporations deriving their chief income from Government contracts shall be taken out. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited.[107]

Different Fiscal Years of Affiliated Corporations. In the case of all consolidated returns, consolidated invested capital must be computed as of the beginning of the taxable year of the

106 A domestic corporation seeking such credit must comply with those provisions of subdivision (a) of Reg. 45, Art. 383 which are applicable to credits for taxes already paid, except that in accordance with article 611 the form to be used is form 1118 instead of form 1116.

107 Reg. 45, Art. 637. A consolidated return for federal tax purposes is to be distinguished from a consolidated statement for submission to stockholders. This is because, among other things, a foreign corporation will not be deemed to be affiliated with a domestic corporation (Reg. 45, Art. 636), nor will a corporation 50% or more of whose gross income was derived from Government contracts made between April 6, 1917, and November 11, 1918, be deemed to be an affiliated corporation (Reg. 45, Art. 635). Moreover, in the case of two companies, one of which holds between 50 and 95% of the stock of the other, a consolidated return might not be required by the Treasury Department.

parent or principal reporting company and consolidated income must be computed on the basis of its taxable year.[108] Whenever the fiscal year of one or more subsidiary or other affiliated corporations differs from the fiscal year of the parent or principal corporation, the Commissioner should be fully advised by the taxpayer in order that provision may be made for assessing the tax in respect of the period prior to the beginning of the fiscal year of the parent or principal company.[109] In any case where an affiliated corporation has made its income tax return on the basis of a taxable year different from that on the basis of which a consolidated excess-profits tax return in which it is included has been made, an amended income tax return may be made on the basis of the same taxable year as the consolidated return, even though notice was not given within the time prescribed.[110] In such case an amended income tax return should also be made for any unaccounted for portion of the corporation's taxable year.[111]

LIBERTY BOND EXEMPTION IN CASE OF AFFILIATED CORPORATIONS. In case of consolidated returns, affiliated corporations are treated as if they were not affiliated and each corporation is entitled to the same full benefits under the exemption provisions of the several Liberty Bond Acts to which it would be entitled if separate returns were made.[112]

PREPARATION OF CONSOLIDATED BALANCE SHEETS. In the preparation of consolidated balance sheets it is extremely important (1) to reconcile inter-company current accounts, allocating any differences to the proper asset or liability account, which includes

108 Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, § 3344. Under the Act of October 3, 1917, it was held that the consolidated return should be made on the basis of the fiscal year of the parent company. As to past periods, the income of subsidiaries was to be computed to the date of the fiscal year of the parent company, and where the accounts did not disclose the profits earned as of such dates, estimates were accepted subject to a correct accounting at the close of the succeeding year. (Letter from Treasury Department dated March 23, 1918; W. T. S. 1918, ¶ 913.)

109 Reg. 45, Art. 638.

110 Reg. 33 Rev., Arts. 211-215; Reg. 45, Art. 26; See Reg. 41, Arts. 77 and 78; T. D. 2662.

111 T. D. 2805.

112 Letter from Treasury Department dated May 21, 1919; W. T. S. 1919, ¶ 1046; reversing letter from Treasury Department dated April 5, 1919; W. T. S. 1919, ¶ 1038; letter from Treasury Department dated April 16, 1919, ¶ 1039.

the surplus or undivided profits account in case of the adjustment of income or expense items, (2) to eliminate inter-company holdings of capital stock, (3) to eliminate the surplus of the subsidiary companies when the capital stock thereof was purchased by the parent or holding company, for an amount equal to, or greater than, the par value of the capital stock plus the surplus of the subsidiary companies at the date of such purchase. When the book value of a subsidiary company in the balance sheet of the holding or parent company is greater than the par value of the stock plus the surplus of the subsidiary at the time of acquisition, the excess should be charged to goodwill. When it is less, the difference should be credited to surplus, unless there is good will of a greater amount either (1) on the accounts of the holding or parent company or of the subsidiary company, or (2) arising from purchases of stocks of other subsidiary companies. If goodwill is not shown separately, the debits and credits should be made to the account in which goodwill is included, instead of to goodwill or surplus. Where one company does not own the entire capital stock of a subsidiary company, it is customary to show the capital stock of the subsidiary company plus the surplus attributable thereto, owned by other stockholders on the consolidated balance sheet as a distinct obligation to such stockholders. Inventories in consolidated accounts should be carefully scrutinized and adjustments made eliminating any inter-company profits reflected therein.

Special Returns of Corporations. In addition to the above mentioned returns required to be filed by every corporation not exempt from tax, several special returns are required annually or at such times as the Commissioner may request of every corporation.

REPORT OF DIVIDEND PAYMENTS. Every corporation, including a personal service corporation, when requested by the Commissioner, is required to render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the tax years and the amount of dividends paid to him, in such form and manner as may be prescribed by the Treasury Department.[113] This return is for the purpose of supplying the Gov-

[113] Revenue Act of 1918, § 254. This section omits the catch-all phrase in modification of payments of dividends—''whether made in cash, its equivalent

ernment with information with which the annual returns of stockholders may be compared, and is more fully discussed in another chapter.[114]

REPORT OF INCOME PAYMENTS. All corporations, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries [115] and employers, making payment to any individual, corporation or partnership of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income (other than dividends and the payments described in the following paragraph) of $1,000 or more in any taxable year, are required to make returns in regard thereto to the Commissioner, setting forth the amount of such payments and the names and addresses of the recipients. In the case of payments of interest upon its bonds, mortgages or deeds or trust or other similar obligations, such return is required from a corporation regardless of the amount paid.[116] This return is for the purpose of supplying the Treasury Department with information to be used in auditing the returns of the taxpayers to whom the income is paid, and is more fully discussed in a later chapter.[117]

REPORTS BY BROKERS. Every corporation doing business as a broker [118] is required, when called upon by the Commissioner, to make a return showing the names of its customers with such details as to the profits, losses or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on the profits or gains of such customer has been paid.[119] This report is for the purpose of information at the source and is more fully discussed in a later chapter.[120]

or in stock.'' See the definition of the term ''dividend'' in Revenue Act of 1918, § 201.

114 See Chapter 39. It will be noted in this provision the Commissioner is given discretion to require or not to require such returns.

115 See the definition of the term ''fiduciary'' in Chapter 6.

116 Revenue Act of 1918, § 256.

117 See Chapter 39.

118 The Revenue Act of 1918 omits the clause defining brokers, ''on any exchange or board of trade or other similar place of business,'' which appeared in the 1916 Law.

119 Revenue Act of 1918, § 255.

120 See Chapter 39. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns.

Payment of the Tax. Ordinarily the tax of corporations is paid in the same manner and subject to the same rules as the tax of individuals.[121] Certain special rules applicable to the payment of the tax by corporations are set forth in the following paragraphs.

LIABILITY FOR TAX AFTER DISSOLUTION. When a corporation is dissolved its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation, for the purpose of ascertaining the gain or loss. Any profit or loss resulting from the sale of capital assets by the trustees or receiver during the process of liquidation is to be merged with the profit or loss resulting from the regular business of the corporation during the same taxable year prior to the taking over of the affairs of the corporation by the trustees or by the receiver.[122] No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition.[123] The assets of a corporation are

121 See Chapter 35.

122 Letter from Treasury Department dated October 24, 1919; I. T. S. 1919, ¶ 3633.

123 Reg. 45, Art. 547; In re Heller Hirsh & Co., 258 Fed. 208. See also Reg. 33 Rev., Art. 205; Reg. 33, Art. 85; T. D. 2209; T D. 2090. Where the officers and directors (being all the stockholders) of a manufacturing company had for many years fraudulently converted to their own use as dividends sums which should have been paid to the government as taxes, and where the company had become insolvent and a sale of the company's property did not satisfy the government's lien, it was held that there is jurisdiction in equity, on the ground of inadequacy of remedy at law, for the appointment of a receiver and for impounding the company's tangible and intangible assets, wrongfully in the hands of the stockholders, and applying them to the payment of the company's obligations to the government. It was not necessary that the government first obtain a judgment. (United States v. Capital City Dairy Co., 252 Fed. 900.) It was held on demurrer under the Corporation Excise Tax Law of 1909 that a corporation could not evade liability for the tax by dissolving before the time when it was required to make a return. (U. S. v. General Inspection & Loading Co., 192 Fed. 223.) When the same case came before the court for trial, it was held that notice addressed to the defendant at the place of its principal office at the time of its dissolution, presumptively

subject to a lien for the payment of taxes, provided the corporation has not been dissolved, and all its assets distributed, prior to the time the list of assessments gets into the hands of the collector.

COLLECTION OF TAX FROM ASSETS. The Revised Statutes,[124] as amended, provide generally with reference to internal revenue taxes that: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties and costs that may accrue in addition thereto, upon all property and rights belonging to such person." The Revenue Act of 1918 provides[125] that "all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act." Under the 1916 Law it was the duty of the Commissioner to send to each collector a list of the companies liable for tax in his district. showing the amounts for which they were liable, within such time that the collector might give the required notice of assessment on or before June first and upon such lists the collections were made. Under the provision of the Revised Statutes above quoted the lien was fixed upon the assets of the corporation when this list came into the collector's hands. Therefore, if the corporation had distributed all of its assets and become dissolved, in the manner provided by law, prior to that time, there was nothing upon which the lien could attach, and consequently no lien existed to secure

received, was sufficient to warrant the collection of penalties (204 Fed. 657). Corporations which were dissolved in 1917, prior to the passage of the 1917 Law, were held subject to tax under the 1916 Law, as amended, and also under the 1917 Law. A corporation so situated was required to make a return covering the period in 1917 during which it was in business prior to its dissolution. If it should previously have made a return covering this period and paid any excess-profits tax under the act of March 3, 1917, it credited the amount of such tax against any excess-profits tax assessable against it under Title II of the act of October 3, 1917. (Reg. 33 Rev., Art. 61.) This ruling was made on authority of Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654. (See letter from Treasury Department dated November 17, 1917; I. T. S. 1918, ¶ 1085.)

124 R. S., § 3186.

125 Revenue Act of 1918, § 1305.

the payment of the tax which might be due from the corporation. The Revenue Act of 1918 changes the system of assessment and collection of the tax and the time when the lien attaches is uncertain. Although the statutes provide for a lien, this particular remedy for collecting the tax is not exclusive, and the Government may resort to the common law method of collecting the same.[126] The dissolution of a corporation does not extinguish its liabilities and through the courts of equity creditors may pursue its assets into the hands of any person who is not a *bona fide* purchaser. The sale of the entire capital stock of a corporation and the distribution of the proceeds of the sale among the stockholders will not defeat or impair the remedy of creditors, if any debts remain unpaid, as the creditors in that event may pursue the proceeds of the sale in the hands of the respective stockholders and compel each one to contribute *pro rata* toward the payment of the debts to the extent of the moneys received on the distribution.[127] This remedy is open to the Government in the same manner as it is to any other creditor for the collection of the tax,[128] but not for collection of the penalty for failure to file returns.[129]

Withholding the Tax at the Source. No withholding takes place on payment of income to domestic corporations. Such corporations are required to withhold the tax on payments of fixed or determinable and annual or periodical gains, profits and income to non-resident aliens, and non-resident foreign corporations and on payment of bond interest as indicated in another chapter.[130]

Foreign Items. Corporations undertaking as a matter of business and for profit the collection of foreign items are required

126 Dollar Savings Bank v. U. S., 19 Wall. 227.

127 Railroad Co. v. Howard, 7 Wall. 392.

128 28 Op. Atty. Gen. 241. See U. S. v. Capital City Dairy Co., 252 Fed. 900 and Note 123.

129 T. D. 1852. In the case of U. S. v. General Inspection and Loading Co., 192 Fed. 223, 204 Fed. 657, judgment was entered for tax, penalty for delay in the payment of the tax, and interest, under the 1909 Law, notwithstanding the fact that the corporation had been previously dissolved. But in this case the assets had not been distributed.

130 See Chapter 40. Under the 1916 Law, as amended, corporations were required to withhold the tax on dividend payments to non-resident foreign corporations, but this is no longer required.

to obtain a license in the manner more particularly set forth in another chapter.[131]

Examination of Corporate Records. All corporate books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the Commissioner for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in accordance with and subject to certain rules which are discussed at length in another chapter.[132]

Penalties. Corporations or their officers or employees are subject in certain cases to penalties, both specific and *ad valorem*, for failing or refusing to make returns, supply information, pay or collect any tax or for willfully attempting in any manner to defeat or evade the tax. Such penalties are more particularly discussed in another chapter.[133]

Personal Service Corporations. Personal service corporations,[134] as such, are not subject to the income tax, but their individual stockholders are taxed in the same manner as the members of partnerships. All provisions of the income tax law relating to partnerships and the members thereof apply so far as practicable to personal service corporations and their stockholders.[135]

Transportation Systems. For the purpose of the recent act[136] providing for the operation of transportation systems while under Federal control four-fifths of the tax—or a tax of 8%—on the net income of corporations in excess of credits for the calendar year 1919 and each calendar year thereafter, is treated as levied by an act in amendment of Title I of the Revenue Act of 1917.[137] The act providing for the operation of transportation systems while under Federal control and for the just compensation of their owners provided that every agreement entered into pursuant thereto between the President and the transportation sys-

131 Revenue Act of 1918, § 259. See Chapter 40.

132 See Chapter 38.

133 See Chapter 36.

134 The subject of personal service corporations is treated in full in Chapter 9.

135 Revenue Act of 1918, § 218 (e).

136 Act of March 21, 1918.

137 Revenue Act of 1918, § 230 (b). For the calendar year 1918 five-sixths of the tax—or a tax of 10%—was so treated.

tems covering the operation thereof while under Federal control and the just compensation of the owners thereof should provide that any Federal taxes "under the Act of October third, nineteen hundred and seventeen, or acts in addition thereto or in amendment thereof, commonly called war taxes," assessed for the period of Federal control beginning January 1, 1918, or any part of such period, should be paid by the carrier out of its own funds or charged against or deducted from the just compensation stipulated in the agreement. Other taxes assessed under Federal or any other governmental authority for the period of Federal control or any part thereof either on the property used or on the right to operate as a carrier or on the revenues or any part thereof derived from operation (not including, however, assessments for public improvements or taxes assessed on property under construction and chargeable under the classification of the Interstate Commerce Commission to investment in road and equipment) are provided to be paid out of revenues derived from railway operations while under Federal control. All taxes assessed under Federal or any other governmental authority for the period prior to January 1, 1918, whenever levied or payable are provided to be paid by the carrier out of its own funds or charged against or deducted from the just compensation. The 4% tax levied under the 1917 Law is paid by the carrier out of its own funds or charged against or deducted from the compensation payable to the carrier, whereas the 2% tax imposed by the 1916 Law is paid out of revenues derived from railway operations while under Federal control. The tax on all income payable by the carrier on its income arising in the calendar year 1918 and subsequent years in excess of the 2% levied under the 1916 Law is accordingly to be paid by the carrier out of its own funds or charged against or deducted from any compensation it may receive by reason of government operation since such excess is treated as levied by the act in amendment of "the Act of October third, nineteen hundred and seventeen or acts in addition thereto or in amendment thereof, commonly called war taxes." [138]

[138] Act of March 21, 1918. This Act also provides: "That moneys and other property derived from the operation of the carriers during Federal control are hereby declared to be the property of the United States. Unless otherwise directed by the President, such moneys shall not be covered into the Treasury, but such moneys and property shall remain in the custody of the

same officers, and the account thereof shall be in the same manner and form as before Federal control. Disbursements therefrom shall, without further appropriation, be made in the same manner as before Federal control and for such purposes as under the Interstate Commerce Commission classification of accounts in force on December twenty-seventh, nineteen hundred and seventeen, are chargeable to operating expenses or to railway tax accruals and for such other purposes in connection with Federal control as the President may direct, except that taxes under Titles One and Two of the Act entitled 'An Act to provide revenue to defray war expenses, and for other purposes,' approved October third, nineteen hundred and seventeen, or any Act in addition thereto or in amendment thereof, shall be paid by the carrier out of its own funds. If Federal control begins or ends during the tax year for which any taxes so chargeable to railway tax accruals are assessed, the taxes for such year shall be apportioned to the date of the beginning or ending of such Federal control, and disbursements shall be made only for that portion of such taxes as is due for the part of such tax year which falls within the period of Federal control."

CHAPTER 11

SPECIAL PROVISIONS APPLYING TO INSURANCE COMPANIES

In general, domestic insurance companies are subject to the same provisions as other domestic corporations, and foreign insurance companies are subject to the same provisions as other foreign corporations. The foregoing chapter should be consulted as to the general provisions relating to corporations and the following chapter should be consulted as to the special provisions applicable to foreign corporations. In the case of insurance companies, both domestic and foreign, certain special provisions govern the calculation of gross income and the allowance of deductions.[1] These special provisions are the subject of this chapter.

Insurance Company. Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. But a corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund if the income and disbursements therefrom are included in the corporation's own return.[2]

Gross Income of Insurance Companies. The gross income of insurance companies is determined in the same manner as in the case of other corporations except that (a) in the case of life insurance companies it does not include such portion of any annual premium received from any individual policy holder as is paid back or credited to or treated as an abatement of premium of such policy holder within the taxable year and (b) in the case of mutual marine insurance companies it does include the gross premiums collected and received by such companies less amounts

1 Revenue Act of 1918, §§ 233 (a) 1 and 2, 234 (a) 10, 11, 12 and 13.
2 Reg. 45, Art. 1508.

paid for reinsurance. The gross income of insurance companies consists of their total revenue from the operation of the business and of their income from all other sources within the taxable year, except as otherwise provided by the statute. Gross income includes net premiums (that is, gross premiums less returned premiums on policies cancelled and premiums on policies not taken), investment income, profits from the sale of assets, and all gains, profits and income reported to the State insurance departments, except income specifically exempt from tax. Premiums received by mutual marine insurance companies which are paid out for reinsurance should be eliminated from gross income and the payments for reinsurance from disbursements. Deposit premiums on perpetual risks received and returned by fire insurance companies should be treated in the same manner, as no reserve will be recognized covering liability for such deposits. The earnings on such deposits must be included in the investment income. A net decrease in reserve funds required by law within the taxable year must be included in the gross income.[3]

Gross Income of Life Insurance Companies. A life insurance company does not include in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year. (a) "Paid back" means paid in cash. (b) "Credited to" means held to the credit of, including dividends applied to pay renewal premiums, to purchase additional paid-up insurance or annuities, or to shorten the endowment or premium-paying period. It does not include dividends provisionally ascertained and apportioned upon deferred dividend policies.[4] (c) "Treated as an abatement of premium"

[3] Revenue Act of 1918, § 233 (a) 1 and 2; Reg. 45, Art. 548; Reg. 33 Rev., Art. 239. Where there has been a decrease in reserve funds the amount of the decrease is commonly called released reserve, and is to be treated as income for the year in which the reserve is released. (Reg. 33 Rev., Art. 240.) Released reserves though not mentioned in express terms in the law have been held to the taxable income for the year in which released. (Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. This case is now No. 73 on the docket of the United States Supreme Court.) Under the 1909 Law premiums were income of the year of receipt (Lumber Mut. Fire Ins. Co. v. Malley, 256 Fed. 380).

[4] Revenue Act of 1918, § 233 (a) 1; Reg. 45, Art. 549. It was held under the 1916 Law that in so far as "deferred dividends" payable at a stated period

means of the premium for the taxable year. Where the dividend paid back is in excess of the premium received from the policyholder within the taxable year there may be excluded from gross income only the amount of such premium received, and where no premium is received from the policyholder within the taxable year the company is not entitled to exclude from its premiums received from other policyholders any amount in respect of such dividend payment.[5]

Deductions Allowed Insurance Companies. Insurance companies are entitled to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts. "Paid" includes "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income is computed) during the taxable year, but does not include any estimate for losses incurred but not reported during the taxable year. As payments on policies there should be reported all death, disability and other policy claims (other than dividends as above specified) paid within the year, including fire, accident and liability losses, matured endowments, annuities, payments on installment policies and surrender values actually paid.[6]

represented "a portion of any actual premium received," they might be omitted from gross income for the year in which they were actually paid back, except that so much of any deferred dividends paid during the tax year to the individual policyholder as exceeded the amount of premiums paid during the same year might not be omitted; that only the actual amount of dividends actually credited or apportioned to a policyholder during the premium-paying period, and not any accretions thereto, could be excluded from gross income. In the case of whole life or five-year distribution policies, deferred dividends could be excluded from gross income to the extent that they were paid back or credited to the insured or used as an abatement of annual premiums. (Reg. 33, Art. 100.)

[5] Revenue Act of 1918, § 233 (a) 1; Reg. 45, Art. 549; Reg. 33 Rev., Art. 241. Under the 1909 Law there was much litigation as to whether so-called dividends paid by insurance companies to policyholders as a return of a part of the premium were properly deductible. The courts held that the so-called dividends awarded annually to policyholders did not constitute income (Herold v. Mutual Benefit Insurance Co., 201 Fed. 918, affirming 198 Fed. 199) and at the time of the enactment of the 1913 and 1916 Laws the point was expressly covered by substantially the same language as in the present law.

[6] Revenue Act of 1918, § 234 (a) 10; Reg. 45, Art. 568. Surrender values

Deduction of Required Addition to Reserve Funds by Insurance Companies. Insurance companies may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds. This is considered to mean the net addition required by the specific statutes of the States within which the taxpayer transacts business. A requirement by a State insurance commissioner that a net addition shall be made to certain amounts retained to meet specified liabilities is not a net addition required by law to be made to reserve funds within the meaning of the statute. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. Casualty companies may deduct losses incurred within the taxable year; but unless the net addition to the unpaid loss reserve required by law exceeds such losses incurred, no deduction for the net addition to the unpaid loss reserve may be taken. In any event only the excess of such net addition over such losses may be deducted. In the case of life insurance companies the net addition to the "reinsurance reserve" and the "reserve for supplementary contracts [7] not

applied in any manner, consideration for supplementary contracts, involving and not involving life contingencies, should be included in the gross income of life insurance companies. Applied surrender values and consideration for supplementary contracts not involving life contingencies included in income are deductible as payments under policy contracts, but for convenience in verifying the returns these items should appear in the return in gross income and deductions. (Reg. 33 Rev., Art. 241.)

7 Where a life insurance company's policies contain an option to have proceeds paid in annual installments for a given term of years, or during the lifetime of the beneficiary, instead of in one sum, such policies, if the option is exercised, are styled "supplementary policy contracts." These obligations are protected by reserves, the net additions to which are deductible if such reserves are "required by law." The Commissioners of Insurance of all the states require the establishment of a reserve to cover the obligations of the company on such supplementary policy contracts. This fact of itself tends strongly to show that they are required by law, (Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918) but if the action of a commissioner of insurance is based in such cases upon the practice of his office and

involving life contingencies," and the net addition to any other reserve funds necessarily maintained for the purpose of liquidating policies at maturity, are legally deductible. An increase in the reserve maintained by a life insurance company to pay dividends on deferred dividend policies may not be deducted from gross income. Mutual hail and mutual cyclone insurance companies are entitled to deduct from gross income the net addition which they are required to make to the "guaranty-surplus" fund or similar fund.[8]

Special Deductions Allowed in the Case of Combined Life, Health and Accident Policies. Corporations which issue combination policies of life, health and accident insurance on the weekly premium payment plan, continuing for life and not subject to cancellation, may deduct from gross income only such portion of the net addition not required by law made within the taxable year to reserve funds as is needed for the protection of the holders of such combination policies. In general the net addition to any fund especially maintained for the protection of such policyholders may be deducted. The determination by the company of the need for

not upon an express requirement of law, deduction may not be made. (See Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451.)

[8] Revenue Act of 1918, § 234 (a) 10; Reg. 45, Art. 569. Except in the case of corporations issuing policies covering, life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation (see Revenue Act of 1918, § 234 (a) 11), the income tax law specifically limits the deductions to sums *required by law*, not such reservations as business prudence may suggest, and the express provisions of the law fix the determining basis. (Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. This case is now No. 73 on the docket of the United States Supreme Court.) Under the laws of Pennsylvania reserves against unpaid losses are required by law of casualty companies, but not of fire and marine insurance companies. Hence, the latter cannot deduct reserves against losses, although the Insurance Commissioner of Pennsylvania may require such reserves under a practice of his office established for many years and relied upon as an administrative interpretation of the law of that state. (See Insurance Company of North America v. McCoach, 218 Fed. 905, reversed 224 Fed. 657, 661, writ of certiorari granted, 241 U. S. 694, reversed 244 U. S. 585; T. D. 2501.) It has been held that the act addition may be based upon the highest authorized reserve required by the statutes of any State in which the company does business, but that, having adopted the requirements of one State, a company cannot base its reserve upon the requirements of another State for subsequent years (T. D. 1727; Reg. 33 Rev., Art. 240).

such addition is subject to review by the Commissioner, and the return of income should be accompanied by a full explanation of the basis upon which such fund and the additions to it are determined.[9]

Special Deductions Allowed Mutual Marine Insurance Companies. Mutual marine insurance companies should include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. They may deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with the interest actually paid upon such amounts between the date of ascertainment and the date of payment thereof. The remainder of the premiums accordingly forms part of the net income of the company, except to the extent that they are subject to the deductions allowed insurance companies in general and other corporations.[10]

Special Deductions Allowed Mutual Insurance Companies. Mutual insurance companies (other than mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses and reinsurance reserves. If, however, any portion of such amount is applied during the taxable year to the payment of losses, expenses or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible, and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses or reinsurance reserves, then such payment cannot be separately deducted. An amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like

[9] Reg. 45, Art. 570.

[10] Reg. 45, Art. 571; Revenue Act of 1918, §§ 233 (a) 2, 234 (a) 12. In other respects the companies of this class proceed in the same manner as insurance companies generally.

other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan.[11]

Returns of Insurance Companies. Insurance companies transacting business in the United States or deriving income from sources therein are required to file returns of income. The return should be on form 1120. As an aid in auditing the returns, wherever possible a copy of the report to the State insurance department should be submitted with the return. Otherwise a copy of schedule D, parts 1, 3 and 4, of the report should be attached to

[11] Revenue Act of 1918, §234 (a) 13; Reg. 45, Art. 572. Under the 1916 Law it was provided that "mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus portions of their premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves." (Revenue Act of 1916, §12 (a).) It will thus be noted that in the case of such companies the amount of premium deposits returned to policyholders was excluded from gross income, under the 1916 Law, but under the present law the amount of such deposits will be included therein, and taken as a deduction; and this will also be true of such portions of their premium deposits as are retained for the payment of losses, expenses and reinsurance reserves. Under the above quoted provision of the 1916 Law, the Treasury Department prescribed a special form (Form No. 1030 A) for such companies. In regard to such insurance companies it was ruled under the 1916 Law that the profit or income to be returned in the event of the sale or maturity of capital assets acquired prior to March 1, 1913, was required to be determined upon the basis of the difference between the fair market value of such assets as of that date and the selling price thereof. If the assets were acquired subsequent to March 1, 1913, the loss would be the amount by which the selling price was less than the cost. This profit or income might, for the purpose of the tax, be reduced by the amount of any loss resulting from the same source and ascertained in the same manner. In no event could a loss resulting from the sale or maturity of capital assets exceed the gain within the year from like transactions. (Reg. 33 Rev., Art. 242.) It has been held under the 1913 Law that portions of premiums and accretions received by mutual life insurance companies and returned to policyholders may not be excluded from gross income for the year in which they are returned. (Penn. Mutual Life Ins. Co. v. Lederer, 258 Fed. 81, reversing 247 Fed. 559.)

the return, showing the federal, State and municipal obligations from which the interest omitted from gross income was derived. and a copy of the complete report should be furnished as soon as ready for filing.[12]

Foreign Insurance Companies. Foreign insurance companies are required to report as gross income only the gross income from all sources within the United States. Under the present law it seems that income from the possessions of the United States need not be reported. Income from business transacted by a United States branch or agency of a foreign insurance company which relates to a foreign country must be returned as gross income.[13]

Expenses. The same allowance for expenses is permitted to insurance companies as in the case of other corporations. Insurance companies will be permitted to add to expenses, in lieu of depreciation of furniture and fixtures, the actual cost of repairs, replacements and renewals of such furniture, as reported to the State insurance department, provided that in the case of an original investment, the cost thereof be charged to capital account.[14]

12 Reg. 45, Art. 623.
13 Revenue Act of 1918, § 233 (b); Reg. 33 Rev., Art. 244.
14 Reg. 33 Rev., Art. 240.

CHAPTER 12

FOREIGN CORPORATIONS

The Revenue Act of 1918 provides that the income tax shall be levied, collected and paid for each taxable year upon the net income received *from sources within the United States* by every corporation created or organized outside of the United States, including (1) interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, (2) dividends from resident corporations, and (3) all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.[1] The deductions permitted to foreign corporations are in general the same as those permitted to domestic corporations, but, with the exception of interest and taxes paid or accrued within the taxable year, are allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States are determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[2] It will be noted that the Revenue Act of 1918 expressly includes amounts received representing profits on the manufacture *and* disposition of goods within the United States. Income from rentals and royalties from property and income from business carried on in the United States, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States and income from services rendered or labor performed within the United States are also included within the term "sources within the United States."[3]

[1] Revenue Act of 1918, §§ 230 (a), 233 (b), 200.
[2] Revenue Act of 1918, § 234 (b).
[3] Reg. 45, Art. 91.

Definition. As used in this chapter, the term "foreign corporation" means a corporation, association, joint-stock company or insurance company created or organized outside the United States[4] including only the states, the territories of Alaska and

[4] See Revenue Act of 1918, § 1; Reg. 45, Art. 1508. It is interesting to note in this connection the difference between the American and British theories of residence in regard to corporations. The definition given in the text and the definition of the term "domestic" when applied to corporations (Revenue Act of 1918, § 1) is founded upon the American conception that a corporation cannot migrate but must be and remain always a resident of the state or jurisdiction in which it is created. (See Paul v. Virginia, 8 Wall. 168.) This theory contemplates strictly the artificial entity of the corporation. The British statute provides: "For and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any kind of property whatever, whether situate in the United Kingdom or elsewhere, and for and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any profession, trade, employment, or vocation, whether the same shall be respectively carried on in the United Kingdom or elsewhere, and to be charged for every twenty shillings of the annual amount of such profits and gains: And for and in respect of the annual profits or gains arising or accruing to any person whatever, whether a subject of her Majesty or not, although not resident within the United Kingdom, from any property whatever in the United Kingdom, or any profession, trade, employment, or vocation exercised within the United Kingdom, and to be charged for every twenty shillings of the annual amount of such profits and gains." While the cases decided under this statute upon this point are in some confusion, coming to different conclusions upon substantially the same facts and the same conclusions upon different theories, and while in many of them the Appellate Court was constrained to its conclusions by cases stated unfavorably to the taxpayer and the rule that the judgment of the commissioners on questions of fact could not be disturbed, the courts definitely renounce the place of incorporation, as a test of residence. In De Beers Consolidated Mines v. Howe (1906) App. Cas. 455, Lord Loreburn, L. C., said: "In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad." Again in San Paulo Ry. Co. v. Carter (1896) App. Cas. 31, Lord Halsbury said: "It seems to me that, as was said by Cockburn, C. J. in the case of Sulley v. Attorney-General (1), 'it is probably a question of fact where the trade is carried on,' and it is probably true to say that that phrase may be

Hawaii, and the District of Columbia. Foreign corporations are in

understood in two different senses. It may mean where the goods in respect of which trading is carried on are conveyed, made, bought, or sold; or, speaking of land, where it is cultivated or used for any other purpose of profit. That makes the locality of the goods or the land which are the subjects of the trade to be in a certain sense the place where the trade is carried on, because it is the place where the things corporeally exist, or are dealt with. But there is another sense, in which the conduct and management, the head and brain of the trading adventure, are situated in a place different from that in which the corporeal subjects of trading are to be found. It becomes, therefore, a question of fact, and according to the answer to be given to the question where is the trade in a strict sense carried on, will the assessment be.'' (See also New Zealand Co. v. Stephens, 24 T. L. R. 172; American Thread Co. v. Joyce, 104 L. T. R. 217, approved 106 L. T. R. 171, approved by House of Lords 29 L. T. R. 266.) In addition, the British Courts have taxed many foreign corporations on the theory that they were a mere sham, fiction, or dummy, having no real existence apart from some English corporation which owned and controlled them, and also on the theory that they stood in the relationship of principal and agent toward an English company, so that their profits were in contemplation of law the profits of the principal. (See Colquhoun v. Brooks, L. R. 14 App. Cas. 493; Frank Jones Brewing Co. v. Apthorpe, 15 T. L. R. 113, 4 Tax Cas. 6; United States Brewing Co. v. Apthorpe, 4 Tax Cas. 17; St. Louis Breweries v. Apthorpe, 79 L. T. R. 551; Apthorpe v. Peter Schoenhofen Brewing Co., 80 L. T. R. 395.) It has not been held invariably under the British statute that foreign corporations were taxable when their stock was owned by British corporations. (Bartholomay Brewing Co. v. Wyatt 29 B. 499; Kodak Ltd. v. Clark (1903) 1 K. B. 505, affirmed 88 L. T. R. 155; Gramophone & Typewriter, Ltd. v. Stanley, (1906) 2 K. B. 856, 99 L. T. R. 39). In the last mentioned case the court said: ''The fact that an individual by himself or by his nominee holds practically all the shares in a company may give him the control of the company in the sense that it may enable him by exercising his voting powers to turn out the directors and to enforce his own views as to policy, but it does not in any way diminish the rights or powers of the directors, or make the property or assets of the company his as distinct from the corporation's. Nor does it make any difference if he acquires not practically the whole, but absolutely the whole of the shares. The business of the company does not thereby become his business. He is still entitled to receive dividends on his shares, but no more * * * The profits of a corporation are not profits of any business carried on by him in a foreign country, because the individual corporator does not carry on the business of the corporation. He is only entitled to the profits of that business to a certain extent freed and ascertained in a certain way depending on the constitution of the corporation and his holding in it. This legal proposition that the legal corporator cannot be held to be wholly or partly carrying on the business of the corporation is not weakened by the fact that the extent of his interest in it entitles him to exercise a greater or less control over the manner in which that business is carried on. Such control is inseparable from his

fact divisible into four classes, as follows: (1) "non-resident foreign corporations," which have no office or place of business in the United States; (2) "non-resident foreign corporations with a branch in the United States," which have their principal or head business office in a foreign country, but incidentally have branch offices or places of business in the United States; (3) "resident foreign corporations" which have their principal or head business office in the United States and do business solely in this country, and (4) "resident foreign corporations having branches outside the United States" which have their principal or head business office in the United States, but incidentally have branch offices or places of business outside the United States.[5] In this chapter, however, a foreign corporation engaged in trade or business within the United States or having an office or place of business therein will be referred to as a "*resident* foreign corporation" and a for-

position as a corporator and is a wholly different thing both in fact and in law from carrying on the business himself. The directors and employees are not his agents, and he has no power of giving directions to them which they must obey. This shows that the control of individual corporators is something wholly different from the management of the business itself. * * * In order to succeed the Attorney-General must, I think, make out either first, that the German company is a fiction, a sham, a simulacrum, and that in reality the English Company and not the German company is carrying on the business; or secondly, that the German company, if it is a real thing, is the agent of the English company. In Kodak Limited v. Clark (ubi sup.) by way of contrast the English company owned 98 per cent. of the shares. It is true that they did not own them all, but that was not the ground of the decision. The ground was that, while the English company as holding 98 per cent. of the shares no doubt had the control, they had it only as shareholders, and it was the corporation and not the shareholders who were carrying on the business." The American courts have recently shown a decided tendency to depart from the strict doctrine of corporate entity upon which the present distinction between domestic and foreign corporations is founded (see Southern Pacific Co. v. Lowe, 247 U. S. 330; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71; McCaskell Co. v. U. S. 216 U. S. 504; Contra, U. S. v. Nipissing Mines Co. 206 Fed. 431, 234 U. S. 765; Conley v. Mathieson Alkali Works, 190 U. S. 406; Peterson v. Chicago etc. Co., 205 U. S. 364; People v. American Bell Co., 117 N. Y. 255); and the recent ruling of the Treasury Department that dividends on stock and interest on notes of corporations organized in the United States (viz., "domestic" corporations, Revenue Act of 1918, § 1) but doing no business and owning no property therein paid to non-resident alien individuals and corporations are not subject to tax (Reg. 45, Art. 92) is more consistent with the British than the American theory.

[5] See T. D. 2401; Reg. 33 Rev., Art. 200.

eign corporation not having any office or place of business therein will be referred to as a "*non-resident* foreign corporation."[6]

Corporations Exempt from the Tax. The corporations enumerated in the law as exempt[7] include foreign corporations as well as domestic corporations, except as stated in the chapter on exempt organizations.[8]

Corporations Subject to the Tax. All foreign corporations receiving income from sources within this country and not specifically exempt, as indicated in the preceding paragraph, are subject to the tax. It is not necessary that foreign corporations should be engaged in business in this country or that they have an office, branch or agency in the United States. Liability to the income tax attaches with respect to any income, the source of which is in the United States.[9]

Income Subject to Tax. The gross income of a foreign corporation includes only the gross income from sources within the United States.[10] From the amount of such gross income may be subtracted the sum of the deductions enumerated in the law, with the exceptions and subject to the limitations indicated in the introductory paragraph of this chapter.[11]

Income from Sources Within the United States. While the United States has power to tax a foreign corporation for the privilege of doing business in the United States and such tax may be based upon the net income,[12] the Revenue Act of 1918 levies "*upon the net income* of every corporation, a tax at the following rates * * *."[13] In the case of foreign corporations "gross income in-

[6] Reg. 45, Art. 1508.

[7] Revenue Act 1918, § 231.

[8] See Chapter 13.

[9] Reg. 33 Rev., Art. 66. See p. 190 on which the word "source" is discussed and where it is shown that the receipt of income from sources within the United States, rather than the doing of business within the United States, is the test as to the taxability of foreign corporations; in other words, that the Revenue Act of 1918 as to *foreign* as well as domestic corporations is an *income* not an excise tax law.

[10] Revenue Act of 1918, § 233, (b).

[11] Revenue Act of 1918, § 234 (b). See p. 198.

[12] The Act of August 5, 1909, was an excise tax law, both with respect to domestic and foreign corporations, measured with reference to net income. (Flint v. Stone-Tracy Co., 220 U. S. 107.)

[13] Revenue Act of 1918, § 230 (a).

cludes only the gross income *from sources within the United States* * * *."[14] The net income of foreign corporations is computed by deducting from such gross income the items specified in the statute, including, among other things, expenses, losses, bad debts and depreciation, "if and to the extent that they are connected with income arising *from a source within the United States*."[15] This language is evidently an attempt to tax income arising from "sources within the United States," rather than the right of doing any thing or enjoying any privilege in the United States.[16] It will be noted that the 1916 law was the first law using the expression "sources within the United States,"[17] the 1913 Law having used the phrase "business transacted and capital invested within the United States."[18] The word "source" conveys only one

[14] Revenue Act of 1918, § 233 (b).

[15] Revenue Act of 1918, § 234 (b).

[16] This conclusion is supported by a consideration of the historical circumstances under which the Acts of 1909, 1913 and 1916 and 1918 were passed. The Act of August 5, 1909, which has been held to be an *excise* tax law, imposing a tax measured by net income, was necessarily so, because the constitutional authority of Congress "to lay and collect taxes on *incomes* from whatever source derived, without apportionment" was first granted by the Sixteenth Amendment to the Constitution, which was adopted in 1913, and the constitutionality of the 1913 Law has been sustained *as an income tax* on the basis of this constitutional amendment (Brushaber v. Union Pacific R. R. Co., 240 U. S. 1). The Sixteenth Amendment was adopted plainly with the view of relieving *income* taxes from apportionment and the Revenue Act of 1916, and the Revenue Act of 1918, as well as the Act of October 3, 1913, were passed as *income* taxes in consequence of the relief granted by the Sixteenth Amendment. Further, the so-called capital stock tax, imposed by the Revenue Act of 1918, (§ 1000 et seq.) is an excise tax for the privilege of doing business and it is self-evident that Congress did not intend to impose two taxes for the same privilege.

[17] The 1916 Law provided that the income tax should be "levied, assessed, collected and paid annually upon the total net income received in the preceding calendar year from all *sources within the United States* by every corporation, joint-stock company or association, or insurance company, organized, authorized, or existing under the laws of any foreign country including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, and including the income derived from dividends on capital stock or from net earnings of resident corporations, joint-stock companies or associations, or insurance companies, whose net income is taxable under this title." (Revenue Act of 1916, § 10 (a).)

[18] Under the 1913 law foreign corporations were taxable only upon the "net income accruing from business transacted and capital invested within

idea—that of origin.[19] It is defined in the Standard Dictionary as follows: "That from which any act, movement, or effect proceeds; a person or thing that originates, sets in motion, or is a primary agency in producing any course of action or result; an originator; creator; origin. A place where something is found or whence it is taken or derived." This is its natural, ordinary, and familiar meaning, and it is particularly true that terms used in statutes describing objects of taxation should be construed according to their popular signification.[20] The intention of Congress seems to have been to discard the 1913 basis of taxing foreign corporations on income accruing from "business transacted and capital invested" in the United States, as well as the 1909 excise basis and to tax such corporations on income arising from "sources within the United States." The object of this phrase may well be, on the one hand, to prevent foreign corporations from deriving income from the United States free from tax by virtue of a technical construction of the phrase "business transacted and capital invested"[21] and, on the other hand, to prevent the undue imposition of a tax on foreign corporations when the real source of their income is not within this country. The Revenue Act of 1918 goes further than the 1916 Law in expressly citing certain kinds of income[22] as being from "sources within the United States" and the two most recent acts mark a long step in advance towards international comity in taxation[23]—a sincere

the United States." The similarity between the 1913 law and the British law which taxes non-resident foreign corporations on gains arising or accruing from "any trade as exercised within the United Kingdom" should be noted. See note 4.

[19] The word "source" has been defined by regulation to mean "the place of origin of income". (Reg. 33 Rev., Art. 66.)

[20] DeGanay v. Lederer, 250 U. S. 376, decided June 9, 1919. See Chapter 47 for other cases on this point.

[21] See Attorney General's opinions under date of October 23, 1913, and July 15, 1914, as to taxability of interest on bonds and dividends on stock under the language of the Act of October 3, 1913, with respect to non-resident aliens, as one of the reasons for adopting the phrase "sources within the United States."

[22] Compare Revenue Act of 1918, § 233 (b), and Revenue Act of 1916, § 10 (a).

[23] The evil of double taxation as between the States of this country was deprecated by Mr. Justice Holmes in Kidd v. Alabama, 188 U. S. 730, at p. 732, where he said: "No doubt it would be a great advantage to the country

regard for the essentially just and proper jurisdictional limitation upon the exercise of the sovereign power and an avoidance of taking constructive jurisdiction for the purpose of taxing income which rightly should not be levied upon to defray the burdens of government in the United States.

FOREIGN CORPORATIONS MANUFACTURING AND DISPOSING OF GOODS IN THIS COUNTRY. As a general rule, where a foreign corporation has one or more branches in this country, it is a safe presumption that it is in receipt of income from sources within this country, especially if the business such branches transact is profitable. The distinction between doing business with the country and receiving income from sources herein must, however, be constantly noted. The provision [24] of the Revenue Act of 1918 that gross income shall include, in the case of foreign corporations, all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture *and* disposition of goods within the United States, read strictly, seems to impose a tax only on the profits arising from the disposition in this country of goods which have been manufactured here. The ruling [25] of the Treasury Department under this provision of the law refers to profits on the "manufacture *or* disposition of goods within the United States" as being income from sources within the United States. The use of the disjunctive particle "or" broadens the sense of the phrase to include profits on the sale of goods which have *not* been manufactured in the United States, and is a doubtful interpretation of the language of the statute in view of the general rules of construction applicable to taxing statutes that in case of doubt the language will be construed in favor of the taxpayer,[26] and that the word "and" is never construed to mean "or" in the absence of cogent reasons for so doing.[27] Broadly speaking, however, the commercial history of any article involves two main considerations. The article is (a)

and to the individual states if principles of taxation could be agreed upon which did not conflict with each other, and a common scheme could be adopted by which taxation of substantially the same property in two jurisdictions could be avoided."

[24] Revenue Act of 1918, § 213 (c), § 233 (b).

[25] Reg. 45, Art. 91.

[26] Gould v. Gould, 245 U. S. 151. See chapter 47.

[27] Rice v. U. S., 53 Fed. 910.

manufactured—made from other products into its present state or form—and (b) disposed of. These two considerations indicate the popular distinction between "manufacturing" and "mercantile" corporations. Either or both of these processes may bring a profit and the intent of the law may be to tax the profit arising from either or both, if either or both occur in this country. The place where title to goods disposed of passes, or the place where the contract of sale or payment is made, are inconclusive tests for determining whether the goods have been disposed of within this country, since they may be arbitrarily selected by the parties in contemplation of tax liabilities. Moreover, the mere American citizenship or residence or domicile of a purchaser of an article which is sold or disposed of cannot be said to render an article one disposed of in the United States. The location of the vendee or purchaser may be important as a means of ascertaining whether goods have been disposed of within the United States, but it is not important *per se;* it is important only insofar as it may determine the place of the efforts and activities resulting in the disposition. In other words, the place where salesmanship is performed in making a disposition of goods, and not the citizenship or the residence of the vendee, the place where title passes, or the place where the contract or payment is made, would seem to be the true test to be applied in the consideration of the question whether or not goods are disposed of within the United States.

SALE OF GOODS BY CORRESPONDENCE. No attempt was made to impose the 1916 tax on transactions in which a foreign corporation sells goods in this country by correspondence, or delivers goods so sold to a citizen or resident of this country. The conclusion seemed to be that such sales did not create any income from sources within the United States where the contract for the sale of goods was made in a foreign jurisdiction, whether the title to the goods passed in the foreign jurisdiction or title was retained after the goods arrived in this country until payment therefor had been made. Where, however, a resident of this country pays interest on any deferred payments of purchase price the interest is clearly subject to tax under the express provisions of the 1916 and the 1918 Law.[28]

[28] Revenue Act of 1916, § 10 (d); Revenue Act of 1918, § 233 (b).

FOREIGN CORPORATIONS HAVING BRANCHES IN THE UNITED STATES DOING BUSINESS ABROAD. If branches of a foreign corporation within the United States transact business in foreign jurisdictions, the net income accruing to the branch here, it seems that the income derived from such business in foreign jurisdictions should be treated as income from sources within this country, since the management and conduct of such business is directed from within this jurisdiction and the foreign corporation eventually receives its net income from a source within this country, namely, the branch conducting such business.[29]

FOREIGN CORPORATIONS HAVING NO OFFICE OR AGENT IN THIS COUNTRY, COLLECTING COMMISSIONS. It was ruled under the 1916 Law that a foreign corporation located at Singapore, having no office or agent in the United States, which was engaged in the commission business, and which during the year 1917 sold at Singapore and in nearby countries certain products of manufacturing establishments in the United States—the purchase price of the goods being transmitted by the purchasers to the manufacturers and American houses direct, and when the money was received in the United States a commission being paid out of the proceeds of sale to the Singapore corporation—was not in receipt of income derived from sources within the United States; also that should an American corporation receive these commissions from the manufacturer and transmit them to the Singapore corporation, where it simply acted as agent for the Singapore corporation in receiving and transmitting such commissions and retained no part thereof for its own use, it need not report them as its own income.[30]

TRAVELING SALESMEN. The Treasury Department has held as follows: Where a foreign corporation sends a representative to this country to solicit business, the merchandise thus sold to be shipped direct to the consignee, the corporation is transacting

29 The place of management and conduct of the business of a corporation is considered decisive even as against corporate entity and foreign organization as to its residence for tax purposes under the British Law. (See De Beers Consolidated Mines v. Howe, (1906) App. Cas. 455; American Thread Co. v. Joyce, 104 L. T. Rep. 217, affirmed 106 L. T. Rep. 171, approved by House of Lords, 29 T. L. R. 266.) See note 4.

30 Letter from Treasury Department dated April 20, 1918; I. T. S. 1919, ¶ 2299.

business in this country. The fact that the solicitor or representative has only a mailing address in this country, is immamaterial, as he is none the less an agent of the foreign corporation. To the extent that he sells in this country goods or merchandise for the foreign corporation, to that extent the foreign corporation is transacting business in the United States and is required to make a return to the collector in the district in which its representative has his mailing address.[31] An agent who is doing business in this country, buying and selling certain products of the foreign corporation, is to all intents and purposes a branch of the foreign corporation as through and by him the foreign corporation is transacting business here. The buying and selling of products in this country through a local agency or branch is clearly transacting business here.[32] Under the 1913 Law it was held that a foreign corporation was subject to the tax on income accruing from business transacted and capital invested within the United States, where (a) it sent agents into the United States to solicit purchasers for its products, hiring desk room in the United States and empowering the salesmen to make written contracts, (b) shipped its product consigned to itself in the United States to different points where it hired storage rooms and stored the product in its own name and at its own risk to insure delivery according to contract, and to meet anticipated demands.[33]

[31] T. D. 2161.

[32] T. D. 2137. The Treasury Department mentions the *buying* as well as the *selling* of products in this country as a test of whether or not a foreign corporation is doing business here. The propriety of *buying* as a test may be seriously doubted. In Commonwealth v. Standard Oil Co., 101 Pa. St. 119, the court said: "That the purchase of oil in the State by a foreign corporation for the purpose of shipping to its refineries without the state, is doing business within the State, is a proposition that does not need serious discussion. * * * Thousands of corporations and individuals in other states make their purchases of supplies of raw materials here, but it has never been seriously asserted that they were doing business within the State. It has not been the policy of the State at any time, as evidenced by its tax laws to embarrass the development and sale of her rich products, agricultural and mineral, by levying taxes upon strangers who come here to buy, and it is not the province of the courts to erect a judicial Chinese wall around the State, which could not fail to affect injuriously the best interests of the people."

[33] Laurentide Co. Ltd. v. Durey, 231 Fed. 223. The court said in part: "I think it would be somewhat difficult for the Laurentide Co., Ltd., or its able attorney, to describe what it was doing in the United States, if it was not

FOREIGN STEAMSHIP COMPANIES. The tax does not apply to charter money or freight payments received by a foreign owner in regard to a vessel operated between the United States and foreign ports, if the person receiving the income maintains no regular agency in the United States and is not doing business in the United States.[34] Foreign steamship companies engaged in the business of transporting passengers, goods and merchandise between ports in this country and foreign ports and maintaining passenger and freight agencies in this country, are doing business here and are subject to the income tax. There seems to be no constitutional objection involved in such tax being a tax on exports.[35] Foreign steamship companies having no office in the United States, whose vessels only occasionally touch at ports in the United States, were not regarded as doing business in this country within the meaning of the 1909 Law.[36]

doing, carrying on and transacting business therein, when there receiving large quantities of newspaper, consigned to itself and storing it, hiring and paying for storage room therefor, delivering it to customers, purchasers thereof, soliciting contracts by agents for the purchase and supply of same, renting and paying rent for a room for doing the business, depositing and collecting the checks received in payment and paying the expense of the business therefrom, all done in the State of New York in the United States. It was not necessary that the contracts should have been made wholly in the United States, or that their execution or performance should have been wholly in the United States." Under the 1909 Law it was held that where the foreign corporation owned timberlands in this country and operated a match factory but sold its lands and plant, payments to be made in installments, the foreign company to retain the title until paid in full, it was not doing business, although retaining an attorney in the state to look after its interests and an agent for service of process as required by state statute. (Bryant and May, Limited, v. Scott, 226 Fed. 875.) Upon the same state of facts the corporation would be taxable under the present law.

[34] Reg. 45, Art. 92.

[35] 28 Op. Atty. Gen. 211; Aguirre v. Maxwell, 3 Blatch 140; Peck v. Lowe, 247 U. S. 165. It was held under the 1916 Law that where a foreign steamship company had steamers which touched American ports and which carried therefrom freight and passengers its return should show as gross income the total receipts from all *out-going* boats, whether freight or passenger. With the gross income thus ascertained, the ratio existing between it and the gross income from all ports both within and without the United States was determined as the basis upon which deductions might be computed. (Letter from Treasury Department dated July 18, 1916; I. T. S. 1919, ¶ 2294.)

[36] T. D. 1675.

INCOME FROM SERVICES RENDERED. Generally speaking, the "source" of income from services is the jurisdiction in which the services are rendered.[37] Thus, if a foreign corporation receives payment in this country for services rendered entirely without the country, it will be in receipt of no taxable income. Difficult questions are presented, however, as to the taxability of income from services when the services are rendered by foreign corporations partly within and partly without the United States. The true distinction would seem to be that if the services are substantially performed in the United States and only an incidental part in a foreign country, the entire income therefrom should be taxable; and, conversely, if the services are performed substantially in a foreign country and only an incidental part in the United States, the entire income should be exempt.[38] In cases where services by a foreign corporation are performed in a substantial part in the United States and in a substantial part in a foreign country, an allocation should be made of the income in part to sources within the United States and in part to sources without the United States. Where there is no better measure, the expense of rendering of services in the respective jurisdictions should be taken to indicate the proportion of the entire income earned in each jurisdiction.

INCOME FROM INVESTMENTS. Income from investments of all kinds in property located within this country is subject to the tax under the broad provisions of the law which provides for the taxation of the total net income from sources within the United States.[39]

37 Reg. 45, Arts. 91 and 92.

38 See Towne v. Eisner, 245 U. S. 318, in which the court stated that if the plaintiff gained any small advantage by the payment of a stock dividend "it certainly was not an advantage of $417,430, the sum upon which he was taxed." This statement indicates that the courts will not approve the imposition of a large tax based upon insignificant factors of the taxpayer's income.

39 Revenue Act of 1918, §§ 213 (c), 233 (b). Under the 1913 Law the tax was imposed only upon such foreign corporations as were doing business *and* had capital invested in this country. The Treasury Department construed this to mean that the tax applied if a foreign corporation was either doing business *or* had capital invested here and held that money invested in the securities of American corporations was capital invested in the United States regardless of the domicile of the securities or that of the corporation owning them. (Letter from Treasury Department dated June 6, 1916; I. T. S. 1919, ¶ 2307.)

Foreign Governments. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax. The income of foreign ambassadors and ministers from investments in bonds and stocks and from interest on bank balances, and the fees of foreign consuls, are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable. The compensation of citizens of the United States who are officers or employees of a foreign government is, however, not exempt from tax. The exemption of income of foreign governments applies also to their political subdivisions.[40]

Deductions Allowed Foreign Corporations. Foreign corporations are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations, to the extent that such deductions are connected with such gross income, with the exception that the interest deductible is that proportion of so much of the entire interest paid on the corporate indebtedness as would be deductible if paid by a domestic corporation which the gross income from sources within the United States bears to the total gross income, and that full deduction may be made for taxes imposed by the United

In De Ganay v. Lederer, 250 U. S. 376, it was held that the income tax properly applied to income on domestic securities owned by a non-resident alien, which securities were kept in this country.

[40] Revenue Act of 1918, § 213 (b) (5); Reg. 45, Art. 83. Under the 1916 Law, prior to the amendment of October 3, 1917, it was held by the Treasury Department that the income accruing to a foreign government from sources within the United States arising from interest on bonds or dividends on stock of domestic corporations was subject to tax. The 1917 Law provided that the income of foreign Governments received from investments in the United States in stocks, bonds, or other domestic securities owned by them, or from interest on deposits in banks in the United States of money belonging to such foreign Governments was exempt. This did not, however, exempt from the tax any income collected by foreign Governments from investments in the United States in stocks, bonds, or other domestic securities, which were not *bona fide* owned by but were loaned to such foreign Governments. The exemption was and still is predicated upon the fact that the securities or moneys from which income was derived were actually owned by such foreign Governments. (Reg. 33 Rev., Art. 87; T. D. 2425; Revenue Act of 1916, as amended by Revenue Act of 1917, § 30.)

States or any of its possessions, or by any State, Territory, or political subdivision thereof, except taxes for local benefits and income, war-profits and excess-profits taxes.[41] Only the deductions with respect to which special rulings have been made covering foreign corporations are discussed below.[42] The items expressly declared not to be deductible by the Revenue Act of 1918 are equally applicable to domestic and foreign corporations and are discussed elsewhere in this book.[43]

ORDINARY AND NECESSARY EXPENSES. To the extent that they are connected with gross income arising from sources within the United States, foreign corporations may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title or in which it has no equity.[44] A Canadian manufacturing corporation which sells part of its product in the United States and part in Canada should report its deductions for cost of manufacture, exclusive of interest paid on its indebtedness, in the same proportion as the quantity of its product sold in the

[41] Revenue Act of 1918, § 234 (b); Reg. 45, Art. 573. It was required under the 1916 Law that the deductions of a foreign corporation should as nearly as possible represent the actual expenses and authorized charges incident to the income derived from this country, and must not comprehend either directly or indirectly any expenditures or charges incurred in the transaction of business or the investment of capital without the United States. (Reg. 33 Rev., Art. 197; Reg. 33, Art. 157.) The principle followed by the Treasury Department was that all allowable deductions should be computed upon a basis which recognized that the income arising and accruing from business done in and from this country should bear its share, and no more, of expense incident to the earning or creation of such income in the ratio that the gross income arising in and from this country bore to the entire gross income arising from business done both within and without this country. (Letter from Treasury Department dated July 18, 1916; I. T. S. 1919, ¶ 2294.)

[42] See Chapters 21 et. seq. for a general discussion of all deductions and Chapter 10 for a discussion of the deductions as applicable to domestic corporations.

[43] See Chapter 21.

[44] Revenue Act of 1918, § 234, (a) 1, (b).

United States bears to the total quantity sold.[45] Where under the 1916 and prior laws certain expenses, such as coal, ships, stores, etc., in the case of foreign steamship companies, could not be segregated, the total expenses of foreign corporations for such items were pro-rated in such proportion as the gross income of the corporation from sources within the United States bore to the gross income derived from all sources both within and without the United States; that is to say, if one-half of the gross income of the foreign corporation was from sources within this country, one-half of such expense was a proper deduction.[46]

INTEREST. A foreign corporation may deduct that proportion of all interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from income tax to the foreign corporation, which the amount of the gross income of the foreign corporation from sources within the United States bears to the amount of its gross income from all sources within and without the United States.[47]

[45] T. D. 1675; Reg. 33, Art. 116; Letter from Treasury Department dated December 8, 1916.

[46] Reg. 45, Art. 573.

[47] Revenue Act of 1918, § 234 (a) 2, (b), Reg. 45, Art. 573. Foreign corporations were permitted, under the 1916 Law, to deduct part of the interest paid during the year, under the following rules: The indebtedness on which interest was permitted to be deducted could not be in excess of the entire amount of the paid-up capital stock outstanding at the close of the year, or in the absence of capital stock, the entire amount of the capital of the business employed at the close of the year, plus one-half of its interest-bearing indebtedness then outstanding; that is to say, the greatest amount of interest which a foreign corporation could deduct was limited in the same way as in the case of domestic corporations. If the foreign corporation did all its business in the United States, the interest on the amount of indebtedness ascertained as above might be deducted. If it did only a part of its business in the United States there might be deducted only the interest paid on such proportion of the amount of indebtedness ascertained as above as the gross amount of its income for the year from business transacted and capital invested within the United States bore to the gross amount of its income derived from all sources within and without the United States. Foreign corporations were not permitted to deduct the amount of interest on indebtedness incurred for the purchase of obligations or securities the interest upon which was exempt from income tax. The provision of Law (Revenue Act of 1916, § 12 (a)), permitting a deduction

INTEREST PAID BY BANKS ON DEPOSITS. A foreign bank, banking association, loan or trust company, or branch thereof, was permitted under the 1916 Law to deduct in full the interest paid within the year on deposits by or on moneys received for investment from either citizens or residents of the United States and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, or branch thereof.[48] Interest so paid to citizens and residents, being taxable as income to them, seems to be properly deductible from the income of a foreign corporation, but the present law contemplates that all interest shall be apportioned as indicated in the preceding paragraph.

TAXES. A foreign corporation may deduct taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes, or (b) by the authority of any possession of the United States, except income, war-profits and excess-profits taxes, or (c) by the authority of any State or Territory or any county, school district, municipality or other taxing subdivision of any state or territory, or (d) by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed). In the case of (a), (b), and (c) above, the deduction is allowed to foreign corporations without any limit, but in the case of (d), it is allowed only if and to the extent that the taxes are connected with income arising from a source within the United States.[49]

to domestic corporations of the full amount of interest paid on indebtedness secured by collateral, the subject of sale or hypothecation in the ordinary business of the corporation was held not to apply to foreign corporations.

[48] See Reg. 33, Rev., Art. 190 as to the general ruling. No formal ruling was made with respect to foreign corporations but the statement in the text is based on the practice of the Department.

[49] Revenue Act of 1918, § 234 (a) 3, (b); Reg. 45, Art. 573. Under the 1916 Law a foreign corporation might deduct taxes paid within the year imposed by the authority of the United States (except income and excess-profits taxes) or its territories or possessions or under the authority of any State, county, school district or municipality or other subdivision of any State, paid within the United States, not including those assessed against local benefits. This allowance for taxes was the same as that allowed to domestic corporations and to individuals except that it was expressly limited to cases where the tax was

LOSSES. A foreign corporation may deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, to the extent that they are connected with income arising from a source within the United States.[50] It does not seem that the business or property with respect to which the loss is sustained need be located in the United States.[51] A foreign corporation may also deduct worthless debts, losses in inventory and from rebates and net losses if and to the extent that they are connected with income from sources within the United States. This subject is more fully discussed in another chapter.[52]

DEPRECIATION. A foreign corporation may deduct a reasonable allowance for the exhaustion, wear and tear of property used in its trade or business, including a reasonable allowance for obsolescence.[53] The manufacturing need not be conducted in the United States in order to permit any such deduction so long as the income therefrom is taxable in the United States by reason of the sale of the product therein. This subject is more fully discussed elsewhere in this book.[54]

DEDUCTIONS ALLOWED WHEN INCOME IS DERIVED FROM INVESTMENTS ONLY. A corporation deriving its sole income from this country in the form of dividends or interest on domestic stocks and bonds was permitted under the 1916 Law to deduct from the income so received such items of disbursement, loss, etc., as would be properly deductible, if the income were derived from any other source. The deduction comprehended only such expenditures, losses, etc., as were incurred in or were incidental to the creation of the income against which they were charged, and in

assessed by a governmental authority within the jurisdiction of the United States and the tax paid within the United States. (For a general discussion of the extent to which taxes may be deducted see Chapter 24.)

50 Revenue Act of 1918, § 234 (a) 4 and (b).

51 Under the 1916 Law the losses which might be deducted were those sustained in a business conducted in the United States. (Revenue Act of 1916, § 12 (b).)

52 See Chapter 25.

53 Revenue Act of 1918, § 234 (a) 7, (b). The 1916 Law allowed a deduction for depreciation if the business or trade was conducted within the United States (§ 12 (a) Second Clause). The present law allows it if "connected with income arising from a source within the United States."

54 See Chapter 26.

all cases the amounts were required to be within the limits fixed by the 1916 Law.[55]

Credits Allowed to Foreign Corporations. In addition to the above mentioned deductions foreign corporations are allowed the same credits as are allowed to domestic corporations, except the specific credit of $2,000 which is allowed only to domestic corporations.[56] These credits are more fully discussed in another chapter.[57]

Collection of the Tax at the Source. The withholding provisions of the Revenue Act of 1918 applying to foreign corporations are different from the provisions of the 1916 Law.[58] In the case of non-resident foreign corporations, a tax equal to 10% is withheld at the source on payment of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits and income, except that the law requires a tax equal only to 2% to be withheld at the source on all interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a so-called "tax-free covenant."[59] A non-resident foreign corporation cannot by filing any certificate or claim

[55] Letter from Treasury Department dated June 6, 1916, I. T. S. 1919, ¶ 2307.

[56] Revenue Act of 1918, § 236.

[57] See Chapter 31.

[58] Under the 1916 Law, as amended, a normal tax was withheld at the source upon all interest on bonds and mortgages or deeds of trust or similar obligations of resident corporations, and upon all dividends upon the capital stock or from the net earnings of resident corporations. (Revenue Act of 1916, § 13 (c).) There is now no withholding upon income received as dividends from a corporation, which is taxable upon its net income, but with this exception, withholding is required in the case of non-resident foreign corporations upon a more extended class of income, as indicated in the text above. See also Chapter 40.

[59] Revenue Act of 1918, §§ 221, 237. The tax on corporation bonds containing "tax-free covenants" is required by law to be withheld only at the rate of 2% in order to limit the obligation of debtor corporations under those covenants. It seems, therefore, on such bonds the remainder of the income may be paid over without withholding by the debtor corporation. Some plan of collecting the remaining tax, amounting to 8% of the interest paid is no doubt being considered by the Treasury Department, but it is difficult to find a method by which this can be done without increasing the liability of the debtor corporations under their covenants, which liability the law expressly limits.

for exemption prevent the withholding of such tax, but if there is included in such corporation's annual return of all income received from sources within the United States, any income upon which tax has been withheld at the source, the corporation may take credit against the amount of tax due for the amount of the tax so withheld at the source, provided a statement is attached to the return setting forth the source and the amount of the income upon which the tax was so withheld.[60] If a return discloses the fact that the tax withheld exceeds the liability of the corporation, the Treasury Department then orders a refund of the excess amount withheld. For this purpose the return of the foreign corporation should have attached thereto a statement giving the names of the withholding agents and the amounts withheld respectively.[61] There is no collection of the tax at the source on payments of any kind to resident foreign corporations.[62]

INTEREST ON BANK DEPOSITS PAID TO NON-RESIDENT FOREIGN CORPORATIONS. Interest on bank deposits paid to non-resident foreign corporations is subject to tax and withholding of the tax upon such interest is required under the present law.[63]

PROCEDURE IN COLLECTING INCOME SUBJECT TO WITHHOLDING. To enable debtors in the United States to distinguish between resident and non-resident foreign corporations (foreign corporations which have and those which have not any office or place of business in the United States) and also to enable resident foreign corporations to claim exemption from withholding on bond interest or other income, a certificate stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor.[64]

60 Reg. 33 Rev., Art. 201.

61 Reg. 33 Rev., Art. 201. (See also Reg. 33 Rev., Art. 43, Reg. 33, Art. 46, and Chapter 40.)

62 Reg. 45, Art. 362.

63 Under the 1916 Law the Treasury Department did not require withholding in this instance, (T. D. 2652, revoking T. D. 2623) but differentiated between non-resident alien individuals and non-resident foreign corporations, who were recipients of such bank interest, requiring withholding in the case of the former but not in the case of the latter. (See also telegram from Treasury Department, dated February 13, 1918; I. T. S. 1918, ¶ 3082.) The reason for the distinction was that the law required withholding against foreign corporations only on interest from corporate bonds and obligations. (Revenue Act of 1917, § 13 (e).)

64 Reg. 45, Art. 601.

RESIDENT AGENTS FOR FOREIGN CORPORATIONS. In addition to the provisions prescribed by law for the collection of the tax at the source on income paid to non-resident foreign corporations the Treasury Department has evolved a method of collecting the tax by impressing upon residents of this country under certain circumstances the duty of filing returns and accounting for any taxes which may be due from non-resident foreign corporations on the income which passed through the hands of such residents.[65] This duty is discussed fully in another chapter.[66]

Returns of Foreign Corporations. Every foreign corporation receiving income from sources within this country is required to make a return of income, stating specifically the items of its gross income and the deductions and credits to which it may be entitled.[67] It is not necessary, however, in order to be required to make a return, that a foreign corporation shall be engaged in business in this country or that it have any office, branch or agency in the United States.[68]

WHEN FILED. The return of a foreign corporation, like that of a domestic corporation or individual, is filed on or before the fifteenth day of March, or the fifteenth day of the third month following the close of the fiscal year of the corporation, accordingly as the corporation reports on the basis of the calendar or a fiscal year.[69]

WHERE FILED. The return of a foreign corporation should be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.[70]

BY WHOM FILED. The responsibility for filing the return of a foreign corporation rests in some cases on the agent of the foreign corporation in the United States, as indicated in another

65 Reg. 45, Art. 404. See Revenue Act of 1916, § 9 (g), and Chapter 5.

66 See Chapter 5.

67 Revenue Act of 1918, § 239; Reg. 45, Art. 625. Form 1120 (Revised) is used.

68 Reg. 45, Art. 625.

69 Revenue Act of 1918, §§ 241 (a) and 227 (a).

70 Revenue Act of 1918, § 241 (b); Reg. 45, Art. 651.

chapter.[71] When the return is filed by the officers of the foreign corporation, the agent of the corporation in this country is relieved of the responsibility. A foreign corporation having several branch offices in the United States was required, under the 1916 Law, to designate one of such branches as the principal office and to designate the proper officer to make the required return.[72] Agents for foreign steamship companies may sign the required returns if so authorized by their companies. The subject of filing returns in the case of bankruptcy or dissolution is treated in another chapter.[73]

How Prepared. The return of a foreign corporation is prepared in the same manner as the return of a domestic corporation, except that the statements contained therein should relate to income from sources within this country and the deductions should be limited as above indicated.[74]

How Signed and Sworn To. In case the return of a foreign corporation is filed by the home office, it should be sworn to by the president, vice president or other principal officer of the corporation and by the treasurer or assistant treasurer, and be verified in the same manner as is required in the case of domestic corporations.[75] In case the return is signed by the agent for the corporation resident in this country, the affidavit on the form should be changed to show that report is made by such agent, and covers all the income coming into his hands or all the income of the corporation from sources within the United States, as the case may be.

Consolidated Returns. The Revenue Act of 1918 contains a new provision requiring the filing of consolidated returns by affiliated corporations, but this provision does not apply to foreign corporations.[76]

Special Returns. Resident foreign corporations are required to make the same special returns for the purpose of information at the source as are required of domestic corporations.[77] Non-resi-

[71] Reg. 45, Art. 625. See Chapter 5.

[72] Reg. 33, Art. 83.

[73] See Chapter 10.

[74] See p. 198.

[75] Revenue Act of 1918, § 239. As to the general provisions respecting the oath or affirmation, see Chapter 34.

[76] Reg. 45, Art. 632. See Chapter 10.

[77] Revenue Act of 1918, §§ 254, 255 and 256.

dent alien corporations are not required to make special returns by any express provision of the law, but may be called upon under general provisions of the law for information respecting their income from sources in this country.

Duty of Foreign Corporations in Paying Out Income. In paying out income to others subject to the tax, a resident foreign corporation is subject to all the duties and responsibilities imposed upon domestic corporations as to withholding the tax at the source or reporting the names of the persons to whom such income is paid.[78] Non-resident foreign corporations are under no duty in paying out income to others, whether or not such payees are citizens or residents of this country.

Collection of Foreign Items. Resident foreign corporations undertaking as a matter of business or for profit the collection of foreign items are required to obtain a license in the same manner as domestic corporations.[79]

Penalties. Foreign corporations, or their officers or employees, are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make returns, supply information, pay or collect any tax or for wilfully attempting in any manner to defeat or evade the tax. Such penalties are more particularly discussed in another chapter.[80]

78 Revenue Act of 1918, §§ 221, 237 and 256. For a further discussion of this subject see Chapters 40 and 39.

79 Revenue Act of 1918, § 259. See Chapter 10.

80 See Chapter 36.

CHAPTER 13

EXEMPT ORGANIZATIONS

The Revenue Act of 1918, with the exceptions noted below, exempts the same classes of corporations as the 1916 Law. There are fourteen classes of exempt organizations.[1] Exemptions are of two kinds, (1) conditional and (2) unconditional. When the exemption of a corporation is unconditional, and the collector is satisfied that a corporation comes within the exemption he eliminates it from his lists and relieves it from the necessity of making future returns. When the exemption of a corporation is conditional, in order to be relieved from the duty of filing returns of income and paying the tax, it must file with the collector an affidavit setting forth the facts which relate to its right to exemption. The exemptions granted to corporations of the first, second, third, fourth, thirteenth and fourteenth classes enumerated in later paragraphs are unconditional; corporations of the other classes enumerated are only conditionally exempt.[2] Exempt corporations are required to withhold the tax at the source, and to report payments of income to others, in the same manner as is required of taxable corporations.[3]

1 Revenue Act of 1918, § 231. The first eight of these classes were exempt under the 1913 Law; the next five classes were added by the 1916 Law. The 1918 Law discontinues the exemption granted by the 1916 Law to joint-stock land banks and adds an exemption in favor of personal service corporations. Corporations exempt under the 1916 Law were also exempt to the same extent under the 1917 Law (Reg. 33 Rev., Art. 68.)

2 Reg. 45, Art. 511; Reg. 33 Rev., Arts. 67 and 68.

3 T. D. 2693; T. D. 2407; Reg. 33 Rev., Art. 81. Exempt corporations under the 1913 Law were exempt from all provisions of the law, and it was held that this included exemption from the duty of acting as withholding agent, but under the 1916 Law and the present law the rule is as stated in the text. The 1913 Law provided that "nothing in this section" should apply to the corporations enumerated as exempt; the 1916 Law: "there shall not be taxed under this title any income received by" such exempt corporations; the 1918 Law: "the following organizations shall be exempt from taxation under this title."

Foreign Corporations. The exemptions of the 1918 Law apply to foreign corporations as well as to domestic corporations, except in the case of building and loan associations and co-operative banks.[4] In case a foreign corporation desires to be held exempt from the law and doubt exists as to whether or not it comes within the classes of organizations enumerated in the law, it is required to file a copy of its charter or articles of incorporation and by-laws and an affidavit executed by its principal officer showing the sources of its income and its disposition, whether or not any of its income is credited to surplus or may inure to the benefit of any private stockholder, or individual, and in general all facts relating to its operations which relate to its rights to exemption. The question whether or not the organization will be held exempt is determined by the Treasury Department upon the facts so shown.[5]

Exemption Limited to Classes Specifically Enumerated. Any corporation, no matter how created or organized, or what the purpose of its organization may be, is taxable unless it comes within the classes of organizations specifically enumerated as exempt. A corporation is not exempt simply and only because it is primarily not organized and operated for profit. If income within the meaning of the law arises and accrues to a corporation, such income will be subject to the tax unless the corporation is one of the exempt organizations expressly enumerated in the law. Thus, commercial men's associations, and like organizations are not exempt, as they are not expressly enumerated, although they may be corporations not organized for profit.[6]

Where Question as to Right of Exemption Exists. In order to establish exemption, and thus be relieved from the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption, except personal service corporations, file an affidavit with the collector of the district in which

[4] The provisions of § 11 of the 1916 Law were so held. (Letter from Treasury Department dated December 6, 1916; I. T. S. 1919, ¶ 2284.)

[5] Reg. 45, Art. 511; Letter from Treasury Department dated December 5, 1916; I. T. S. 1919, ¶ 2284.

[6] T. D. 2152. See Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. T. D. 2152 also held farmers' mutual fire insurance companies to be taxable, but the 1916 Law subsequently expressly exempted such organizations. The 1918 Law expressly exempts them.

it is located, showing (1) the character and purpose of the organization; (2) the source from which all its income is derived; (3) what disposition is made of such income; and (4) whether or not any of it is credited to surplus or inures or may inure to the benefit of any private stockholder or individual.[7] To such affidavit should be attached a copy of the charter or articles of incorporation and by-laws of the organization. Upon receipt by the collector of the affidavit accompanied by the copy of the charter, or articles of incorporation and copy of the by-laws, he will inform the organization whether or not it is exempt. If, however, the collector is in doubt as to the taxable status of the organization, he will refer the affidavit and accompanying papers to the Commissioner for decision.[8] Where there is any doubt as to the status of a corporation under the provisions of the law, and its exempt status has not been established by the Treasury Department, the annual return should be filed (in blank if desired) and an affidavit attached thereto setting out fully the same information. If the collector is in doubt, he will refer the statement and return to the Commissioner for decision and withhold listing for assessment until a decision is reached.[9]

Right of Exemption Must Be Proved on Request. In the absence of the showing indicated in the preceding paragraph, organizations enumerated as exempt may at any time be required to make returns of income or disclose their books of account to a revenue officer for examination in order that the status of the company may be determined.[10] Having once satisfied the collector as to its right to exemption, a corporation is not required to make a return of income or any further showing with respect to its status under the law unless it changes the character of its organization or operations or the purpose for which it was originally created.[11] Collectors keep a list of all exempt corporations to the end that they may occasionally inquire into their status and

[7] Reg. 45, Art. 511; Reg. 33 Rev., Art. 78.

[8] T. D. 2693.

[9] Reg. 33 Rev., Art. 79. Letter from Treasury Department dated November 1, 1916; I. T. S. 1919, ¶ 2282.

[10] Reg. 33, Art. 88.

[11] Reg. 45, Art. 511; Mimeograph letter to Collectors No. 1148; I. T. S. 1918, ¶ 1201. T. D. 2137.

ascertain whether or not they are observing the conditions upon which their exemption is predicated.[12]

Labor, Agricultural and Horticultural Organizations (first class). The exemption of this class is unconditional. Although the language of the statute is very broad, the law undoubtedly refers only to such organizations as are not organized for profit, have no income inuring to the benefit of their members, and are educational or instructive in character, having for their purpose the betterment of the condition of their members, the improvement of the grade of their products, and the encouragement and promotion of the industries named to a higher degree of efficiency.[13] A corporation engaged in the business of raising stock or poultry, or growing grain, fruits, or other products of this character as a means of livelihood and for the purpose of gain, is an agricultural or horticultural organization only in the sense that its name indicates the kind of business in which it is engaged and, as such, is not exempt.[14] Agricultural corporations owning sugar plantations and disposing of the product thereof have been held to be organized for profit and not entitled to exemption as agricultural organizations under this provision.[15] County fairs or like organizations of a quasi-public character, not themselves engaged in agricultural or horticultural pursuits, and which, by means of awards, prizes or premiums, etc., are designed to encourage better production, and no part of whose income, derived from gate receipts, entry fees, donations, etc., inures to the benefit of any private stockholder or individual, but is used exclusively to meet the necessary expenses or upkeep and operation, are held to be exempt.[16] But societies or associations which have for their purpose the holding of annual or periodical race meets and from which profits inure, or may inure, to the benefit of the members or stockholders are not exempt.[17]

Mutual Savings Banks (second class). This class of organizations is unconditionally exempt. The mutual[18] savings banks

12 Reg. 45, Art. 511; Reg. 33 Rev., Art. 80.
13 Reg. 45, Art. 512; Reg. 33 Rev., Art. 73.
14 Reg. 45, Art. 512; Reg. 33 Rev., Art. 74.
15 T. D. 2090.
16 Reg. 33 Rev., Art. 73.
17 Reg. 45, Art. 512.
18 As to what constitutes a mutual purpose see notes 24 and 34, below.

which are exempt are those not having a capital stock represented by shares. A Massachusetts savings bank, otherwise exempt, which establishes an insurance department under the statutes of that State, does not thereby become subject to tax upon the income received by such department.[19]

Fraternal Beneficiary Societies (third class). Fraternal beneficiary societies, orders or associations are exempt (a) if they operate under the lodge system, or if they are for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) if they provide for the payment of life, sick, accident, or other benefits to the members of such society, order or association or their dependents. One important characteristic of this class of exempt corporations is that they must operate under the lodge system, or be for the exclusive benefit of a society operating under such system. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like.[20] Mutual protective associations not operating under a lodge system are not exempt under this provision since they lack one of the characteristics of this class.[21]

Domestic Building and Loan Associations and Co-operative Banks [22] (fourth class). The exemption applies to building and loan associations organized pursuant to the laws of the United States or of some State or Territory thereof, which accumulate funds to be loaned to their members and to be repaid in small periodical installments. The statute requires that the members of such associations shall share in its profits on substantially the same footing. Subject to this requirement, the fact that the association issues prepaid stock entitled to a specified percentage of the profits does not prevent exemption. Where, however, the association issues paid-up stock, the holders of which are entitled to a fixed dividend and also to share in the profits with all the

19 Reg. 45, Art. 513.

20 Reg. 45, Art. 514; Reg. 33 Rev., Arts. 77 and 239.

21 Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. This case contains an extended discussion on the distinction between a mutual association and a fraternal association.

22 Co-operative banks were included by the 1916 Law.

other holders of stock, it is not exempt.[23] If a corporation by any other name is carrying on an exclusive building and loan business, before it is entitled to exemption it will be incumbent upon it to show to the satisfaction of the Commissioner that it is in fact a building and loan association.[24] Co-operative banks must be

[23] Reg. 45, Art. 515.

[24] Reg. 33 Rev., Art. 70. The 1909 and 1913 Laws provided that "domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members" should be exempt. The 1916 Law contained the following exemption: "domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit." The present law contains the exemption: "Domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit." Under the 1916 Law it was ruled that mutuality in operation and in the distribution of profits and benefits was essential to exemption; that in order to come within the exempted class such associations must not only be domestic, but they must be organized and operated exclusively for mutual purposes and without profit, that is, all profits and benefits provided for in the articles of association and by-laws must be ratably distributed among all the members, regardless of the kind of stock held, according to the amount of money they had on deposit; and that an association issuing different classes of stock upon which different rates of interest or dividends were guaranteed or paid, was not in the exempt class. (Reg. 33, Art. 87.) Under the 1909 Law it was ruled that building and loan associations were not exempt if they loaned money to others than their members, thus doing a business similar to that engaged in by banks or trust companies; and that building and loan associations which received sums of money on deposit not in payment of stock, and on which the depositor received a fixed rate of interest, regardless of the earnings of the association, were conducting a business similar to a banking business and were therefore subject to tax unless they fell within the class of co-operative banks. (T. D. 1655.) Under the 1909 Law it was decided that a building and loan association was exempt although it issued both prepaid and installment stock, but that one issuing preferred stock was not exempt. (Pacific Bldg. & Loan Ass'n v. Hartson, 201 Fed. 1011.) In Herold v. Parkview Bldg. & Loan Ass'n, 203 Fed. 876, the association issued two varieties of stock, one known as prepaid stock on which the full par value of $200 per share was paid by the holder at the time of the issuance of the stock, and upon which the company paid to the holder out of the profits of the association the sum of 5% per annum in lieu of participation by said stockholder in the general profits of the association, and a second stock known as installment stock whereon the holder paid one dollar per share per month and to which was added the proportionate share of the profits of the association after deducting expenses until the aggregate of payments and profits equaled the sum of $200, when the said sum was paid to the holder and the shares retired. The prepaid stock could be cancelled by the corporation at any time upon thirty days' notice and payment of the value thereof together with interest at the rate of

without capital stock and must be organized and operated for mutual purposes and without profit in order to be exempt.

Cemetery Companies (fifth class). A cemetery company having a capital stock represented by shares, or which is operated for profit or for the benefit of others than its members, does not come within the exempted class. A cemetery company of which all lot owners are members, issuing preferred stock entitling the holder to a semi-annual dividend of 4 per cent., and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption.[25]

Religious, Charitable, Scientific and Educational Corporations (sixth class). This exemption applies only to a corporation or association. It does not include the case of a trust, under which the trustee is authorized to use the trust property for religious purposes. In order to be exempt the corporation or association must meet three tests: (a) it must be organized and operated for one or more of the specified purposes; (b) it must be organized and operated exclusively for such purposes; and (c) no part of its income must inure to the benefit of private stockholders or individuals. (1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by im-

5% from the date of last payment of interest, and each holder of such stock could likewise upon thirty days' notice tender his certificate and require payment from the association. The association borrowed no money from individuals whether members or non-members, loaned no money to persons other than members of the association, but borrowed according to its business demands from a local bank. The association was organized under the Act of April 8, 1903 (Public Laws, p. 457), of New Jersey. It was held that mutual benefit does not necessarily mean equal benefit; that a building and loan association is organized and operated for the mutual benefit of its members when they share in the profits on sustantially the same footing; and that exact equality is probably not possible where part of the stock is prepaid and part is installment, but an approximate equality sufficiently close for all purposes is certainly not beyond the reach of calculation.

[25] Reg. 45, Art. 516; Reg. 33 Rev., Art. 71.

proving the efficient administration of justice. Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute. Societies designed to encourage the performance of first class orchestral music are not exempt, the purpose being merely to provide a high grade of entertainment. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration. (2) Where a religious corporation owns a large quantity of farm land and works it, and also manufactures and sells clothing and other articles for profit, it is not operated exclusively for religious purposes and is not exempt, even though its property is held in common and its profits do not inure to the benefit of individual members of the society. (3) It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the by-laws provide that the shareholders shall not receive any dividend or other return upon their shares.[96]

Business Associations (seventh class). Business leagues, chambers of commerce and boards of trade are conditionally exempt; that is, those not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual are exempt. A business league is an association of persons having some common business interest, which limits its

[96] Reg. 45, Art. 517; Reg. 33 Rev., Art. 67.

activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade. An association engaged in furnishing information to prospective investors, to enable them to make sound investments is not such a league, since its members have no common business interest, and it is not exempt, even though all of its income is devoted to the purpose stated. A clearing house association, not organized for profit, no part of the net income of which inures to any private stockholder or individual, is exempt provided its activities are limited to the exchange of checks and similar work for the common benefit of its members. An association of persons who are engaged in the business of carrying freight and passengers by boats propelled by steam, which is designed to promote the legitimate objects of such business, all of the income of which is derived from the membership dues and is expended for office expenses and the salary of a secretary-treasurer, is exempt from tax. An incorporated cotton exchange, whose shares carry the right to dividends, is organized for profit and is not exempt.[27]

Civic Organizations (eighth class). Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt. This class is therefore only conditionally exempt.[28] A corporation having capital stock and possessing a charter which authorizes it to buy, improve and sell real estate is organized for profit within the meaning of the statute and is not exempt from tax as a civic league or organization, even though it no longer exercises such powers for profit and is operated exclusively for the promotion of social welfare.[29]

Clubs (ninth class). Clubs are conditionally exempt. Clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes are exempt if no part of the net income inures to the benefit of any private stockholder or member.[30] This exemption applies to practically all social and recre-

27 Reg. 45, Art. 518.

28 Reg. 33 Rev., Art. 67.

29 Reg. 45, Art. 519.

30 Reg. 33 Rev., Arts. 67 and 72. T. D. 2090. Letter from Treasury Department dated February 12, 1916; I. T. S. 1918, ¶ 1194. Such clubs were held to be exempt under the 1913 Law, although that law did not contain the express

ation clubs which are supported by membership fees, dues and assessments. If a club, by reason of the comprehensive powers granted in its charter, engages in traffic, in agriculture, or horticulture, in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. It thus becomes a business or commercial enterprise, and any profit realized from such activities is subject to the tax, and the club so operated must make returns of income.[31]

CLUB—ACCUMULATING CHRISTMAS FUND. An incorporated club, composed of the employees of a corporation, was organized for social purposes. The only source of income of the club was the initiation fee, and this was expended solely for entertainments. Certain members, called participating members, made contributions to a "Christmas Fund," which fund was invested by the executive committee of the club as it saw fit. Shortly before Christmas in each year the investments were liquidated and the net fund distributed to the participating members in proportion to their contributions. It was held that the club was organized and operated exclusively for pleasure, recreation and other non-profitable purposes and that no part of its net income inured to the benefit of any private stockholder or member. The fact that the executive committee received specific dues from certain members, to be invested in various ways and thereby derived income did not take it out of the exempt class, since the funds so received were not the property of the club and were returned, together with the profit thereon, to the contributing members.[32]

Mutual or Co-operative Organizations of a Local Character (tenth class). Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, and like organizations of a purely local character, the income of which consists solely of assessments, dues and fees collected from members for the sole purpose of meeting expenses incurred in pursuance of the purpose for which the company is organized, are specifically exempt. This exemption is conditional. It should be noted that the essential

exemption which appears in the 1916 and 1918 Laws. (Letter from Treasury Department dated May 4, 1914; I. T. S. 1918, ¶ 1192.)

31 Reg. 33 Rev., Art. 72; Reg. 45, Art. 520.

32 Letter from Treasury Department dated January 12, 1917.

features of this class are as follows: (a) They must be mutual or co-operative; (b) they must be of a purely local character; (c) the income must be solely from assessments, dues and fees collected from members, and such assessments, dues and fees must be used for the sole purpose of meeting expenses,[33] incurred in pursuance of the purposes for which the companies are organized. It is necessary to exemption that the income of the company be derived solely from assessments, dues and fees collected from members. If income is received from other sources, the corporation is not exempt, even though its additional income is tax exempt. Income, however, from sources other than those specified does not prevent exemption where its receipt is a mere incident of the business of the company. Thus the receipt of interest upon a working bank balance, or of the proceeds of the sale of badges, office supplies or equipment, will not defeat the exemption. The same is true of the receipt of interest upon liberty bonds, where they were purchased as a patriotic duty and were afterwards sold. Where, however, such bonds are bought as a permanent investment, the receipt of the interest destroys the exemption. The receipt of what is in substance an entrance fee, charged by a mutual fire insurance company as a condition of membership, does not render the company taxable, although this fee is called a "premium." But the issuance of policies for stipulated cash premiums prevents exemption. A local exchange or association to insure the owners of automobiles against fire, theft, collision, public liability and property damage, is exempt, since it performs functions of the same character as a mutual fire insurance company, and is a "like organization" within the meaning of the statute. A local reservoir and ditch company may likewise be exempt from tax. The exemption does not include a telephone clearing association, whose business is to apportion toll rates between independent telephone companies handling the same calls and whose income consists of compensation paid by such companies and receipts from the sale of form blanks.[34] The phrase "of a purely local character" qualifies only "like organizations."

[33] Reg. 33 Rev., Arts. 69 and 239.

[34] Reg. 45, Art. 521. In connection with this class of exempt corporations the decision in the case of Niles v. Central etc. Ins. Co., 252 Fed. 564, is interesting. The case arose under the Act of Oct. 22, 1914 (38 Stat. 762, c. 331) imposing a stamp tax on insurance policies, and contained an exemption read-

Associations for Marketing Produce (eleventh class). Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expense, on the basis of quantity of produce furnished by them, are exempt.[35] Co-operative associations, in order to come within this exemption, must establish to the satisfaction of the collector or Commissioner the fact that, for their own account, they have no net income, their business being to market the products of their members, and that the entire proceeds of such marketing, less necessary selling expenses, are turned back or paid to the members on the basis of the quantity of produce furnished by them—quality and grade being considered—as the purchase price of such produce. If in the course of their business such associations purchase for cash at a stipulated price articles or produce with a view to selling them for gain, it will be held that such associations are organized for profit and such associations will be required to make returns of annual

ing, "provided that purely co-operative or mutual fire insurance companies or associations carried on by the members thereof for the protection of their own property and not for profit, shall be exempted from the tax herein provided." A mutual fire insurance company was organized under the laws of Ohio, which required the company to (1) charge a cash premium payable at the time of delivery of policies, and (2) to maintain an unearned premium reserve of a definite percentage of the cash premiums on unexpired risks, and which permitted the company to (1) maintain a surplus in excess of the above reserve, as an additional security to policy holders, and (2) to earn interest on both the above reserve and surplus by investing them; the cash premium in excess of the amount estimated as sufficient for the protection and payment of losses at the expiration of each policy being returnable to the policy holder. The company was held to fall within the exemption above quoted, because its primary purpose was not to derive incidental profit from interest on its reserve and surplus, or to undertake investments on behalf of its members, but solely to protect more effectively the property of its members. The court said: "The distinction drawn in the act is between those mixed mutuals, which, though commonly called mutuals, are in fact also doing a non-mutual business for profit, and the strictly mutual companies; not between the mutuals which carry a reserve and surplus, and those which levy assessments only after each loss. A mere incidental profit earned by way of interest on its invested safety funds, or on its bank balances, does not change the purely mutual character of the company, or indicate that its business, though thus earning a profit, is 'carried on for profit.'"

35 Revenue Act of 1918, § 231.

income and include therein, for the purpose of the tax, all incomes derived from such transactions. If amounts paid to members are based solely upon the quantity of produce furnished, such amounts may be deducted from the gross proceeds of sales, and the taxable net income will be the amount of earnings passed to surplus, or distributed or distributable among members on the basis of their stock holdings.[36] A farmers' association is not exempt from taxation where in accounting to farmers furnishing produce for the proceeds of sales it deducts more than the necessary selling expenses incurred. Cooperative associations acting as purchasing agents are not expressly exempt from tax and must make returns of income, but rebates made to purchasers, whether or not members of the association, in proportion to their purchases may be excluded from gross income in computing the net income subject to tax. Any profits made from non-members and distributed to members in the guise of rebates are of course subject to tax.[37]

COOPERATIVE DAIRIES. Cooperative dairy companies, which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among their members upon the basis of the quantity of milk or of butter fat in the milk furnished by such members, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the company will be subject to tax.[38]

Corporations Owned by Exempt Corporations (twelfth class). Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to organizations which are themselves exempt from the income tax are also exempt.[39]

36 Reg. 33 Rev., Art. 75.

37 Reg. 45, Art. 522; T. D. 2737.

38 Reg. 45, Art. 522. Under the 1913 Law, which did not contain the foregoing exemption, it was held that co-operative dairy associations, whether issuing capital stock or not, were not exempt as agricultural organizations. In the preparation of their returns such associations were permitted to deduct from gross income the amount actually paid to members and patrons for milk, but any amount retained at the end of the year over and above expenditures was taxable as income. (T. D. 1996; see also Reg. 33 Rev., Art. 76.)

39 Such corporations were held to be taxable under the 1913 Law in the absence of express provision in that law for their exemption. (T. D. 2137.)

Federal Land Banks and National Farm-Loan Associations (thirteenth class). Federal land banks and National Farm-Loan associations as provided in Section 26 of the Act of July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes," are unconditionally exempt.[40]

Personal Service Corporations (fourteenth class). Since the stockholders of personal service corporations are taxable in the same manner as the members of a partnership,[41] personal service corporations as such are exempt from tax.[42]

Joint-Stock Land Banks. Joint-stock land banks were unconditionally exempt under the 1916 Law, as amended, as to income derived from bonds or debentures of other joint-stock land banks or any federal land bank belonging to such joint-stock land bank. They were taxable, however, as to income from other sources and consequently it would seem they were not exempt from the requirement of making a return of annual income, since the exemption from making returns applied only to corporations not subject to the tax. The present law does not include joint-stock land banks in the list of exempt organizations.[43]

40 Revenue Act of 1918, § 231 (13); Reg. 45, Art. 74; Reg. 33 Rev., Art. 68.
41 Revenue Act of 1918, § 218 (e).
42 Revenue Act of 1918, § 231 (14).
43 Compare Revenue Act of 1916, § 11, and Revenue Act of 1918, § 231.

CHAPTER 14

INCOME—IN GENERAL

The term "gross income" is defined by the statute to include "gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."[1] The general rules and principles applicable to income from all sources will be discussed in this chapter, and thereafter the special rules applicable to income from (1) personal services, (2) business, trade or commerce, (3) sales or dealings in property, (4) interest, rent, and royalties, (5) dividends, (6) miscellaneous sources. The special rules relating to income from partnerships and fiduciaries are treated in the chapters on those respective subjects.[2]

What Constitutes Income. A discussion of the various conceptions of "income" would be interesting but out of place in a work of this character. "Income," like most other words, has

[1] Revenue Act of 1918, § 213 (a). The clause "all other gains and profits derived from any source whatever" contained in the Virginia Income Tax (Acts 1902-04, Chapter 148, as amended by Acts 1912, Chapter 279) has been held not to be limited by the rule of *ejusdem generis* to the specific kinds of income enumerated theretofore (Commonwealth v. Werth, 116 Va. 604, 82 S. E. 695).

[2] See Chapters 8 and 6.

different meanings, dependent upon the connection in which it is used and the result intended to be accomplished by its use.[3] The subject of what constitutes income in the technical or true economic sense is one upon which few economists and courts agree. As used, however, in the Sixteenth Amendment and in the statutes enacted in pursuance thereof, the word must be held to have been used in its common, ordinary meaning, and not in its technical or true economic sense, for it is a familiar rule of construction that ordinary words used in constitutions and statutes must be given their usual and common significance, if such meaning harmonizes with the evident intent of the language employed and with the purpose to be accomplished.[4] In its ordinary and popular meaning "income" is the amount of actual wealth which comes to a person during a given period of time. At any single moment a person scarcely can be said to have income. The word in most, if not all, connections, involves time as an essential element in its measurement or definition. It thus is differentiated from capital or investment, which commonly means the amount of wealth which a person has on a fixed date. Income may be derived from capital invested or in use, from labor, from the exercise of skill, ingenuity, or sound judgment, or from a combination of any or all of these factors.[5] One of the most recent of its definitions is "the gain derived from capital, from labor, or from both combined."[6] It would be difficult to give a comprehensive definition which can be treated as universal and final but the word's usual synonyms are "gain," "profit," "revenue." It is used in this sense also by writers upon taxation and economics.[7] One conception of income excludes gains or increment in the value of capital assets, but this conception was not that of Congress in enacting the recent income tax laws, since the tax is not only upon income conceived as production of capital but also upon gains and profits derived

3 Trefry v. Putnam, (Mass.) 116 N. E. 904, L. R. A. 1917, F. 806.

4 Van Dyke v. City of Milwaukee, (Wis.) 146 N. W. 812, 150 N. W. 509.

5 Trefry v. Putnam, (Mass.) 116 N. E. 904, L. R. A. 1917, F. 806.

6 Stratton's Independence v. Howbert, 231 U. S. 399; Doyle v. Mitchell Brothers, 247 U. S. 179. In U. S. v. Oregon, Washington, etc. Co., 251 Fed. 211, the court held that the term is not limited to earnings from economic capital, i. e. wealth industrially employed in permanent form.

7 Trefry v. Putnam, (Mass.) 16 N. E. 904, L. R. A. 1917, F. 806.

from sales or dealings in capital itself. Property held by the taxpayer on March 1, 1913, the date of incidence of the first income tax law passed pursuant to authority given to Congress by the Sixteenth Amendment, is capital. Included in this capital are all claims, whether evidenced by writing or not, and all interest which had accrued thereon before that date.[8]

BOOKKEEPING ENTRIES. Real facts and not bookkeeping entries constitute income. Books of account are no more than evidential; they are neither indispensable nor conclusive.[9] A book value increase in the value of capital assets due to a re-appraisal of property is not income within the meaning of the law.[10] A book entry reflecting only an enhanced value of assets during the year evidences an increase in the net worth of the corporation or individual for that year, an increase which, under adverse conditions, may disappear the next year. An increase in value thus evidenced is intangible, unstable and is not such income as the law contemplates shall be taxed.[11] Taxable income is that actually realized during the year, evidenced by the receipt of cash or its equivalent. Hence mere book entries of an appreciation in the value of capital assets will be disregarded.[12] Neither the Government nor the taxpayer is bound by valuations entered on the books of the taxpayer.[13] This does not mean that the return of income should not be made in accordance with the taxpayer's books, for ordinarily the books reflect the real or actual facts. It means, for instance, that the Government is not precluded from going behind the taxpayer's books and assessing

8 Reg. 45, Art. 87.

9 Doyle v. Mitchel, 247 U. S. 179; Southern Pacific R. R. Co. v. Muenter, U. S. C. C. A., Ninth Circuit, decided October 6, 1919; I. T. S. 1919, ¶ 3639.

10 T. D. 2005; Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

11 Industrial Trust Co. v. Walsh, 222 Fed. 437; Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 260. See Reg. 45, Art. 23.

12 Reg. 45, Art. 23; Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 260.

13 Doyle v. Mitchell Brothers, 235 Fed. 686, affirmed 247 U. S. 179. In some instances the law places a further determining importance on bookkeeping entries, as in the case of depreciation and in the case of worthless debts. The latter seems to be the only deduction expressly required by the law to be evidenced by book entries in the case of individuals. Under the 1916 Law this was true also of cases of losses, which were required to be sustained and "charged off" in order to be deducted by corporations. (Revenue Act of 1916, § 12 (a).)

the tax on the basis of the actual facts. Where property is carried at a nominal value on the books of the taxpayer, and the Government seeks to assess a tax on the basis of that value, the taxpayer may prove, by other evidence, the true value of such property.[14] As a general rule, the method of accounting employed by a taxpayer determines his income. No system of bookkeeping or accounting is prescribed for all taxpayers, but the business transacted by the taxpayer should be so recorded that he may make a return of his true income and that each and every item set forth in the return of income may be readily verified by an examination of the books of account.[15] The books of a corporation are assumed to reflect facts as to its earnings, etc., hence they will be taken as the best guide in determining the net income, and, except as the same may be modified by provisions of the law wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to stockholders, should be the same as that returned for taxation.[16]

Income Actually Received. The courts have uniformly construed the word "income" to include only the receipt of actual cash as opposed to contemplated revenue due but unpaid, unless a contrary purpose is manifest from the language of the statute; that is, the courts in the absence of a clear direction to the contrary construe a revenue law in accord with an intention to reach actual and not potential income.[17] One cannot be said to reach

14 U. S. v. Guggenheim Exploration Co., 238 Fed. 231. In this case the value at which the property was acquired, the declaration of the board of directors as to such value, at the time of acquisition, and statements in the annual reports, were held to overcome in weight the alleged admission against interest in placing the valuation of the property on the books at a nominal amount.

15 Reg. 45, Art. 24; Reg. 33, Art. 182; T. D. 2161.

16 Reg. 33, Art. 183.

17 U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas., No. 16,228. The language of the 1909 Law, Act of August 5, 1909, § 38 (36 Stats. 112), was held to indicate that the net income, which was the measure of taxation, meant what had actually been received and not that which, although due, had not been received, its payment for any reason having been deferred or postponed. (Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918; Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206.) In Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188, it was held under that law that items of "non-ledger assets" shown in the annual report of a life insurance

an income of defined proportions until he balances receipts and disbursements at the end of a stated period and ascertains, not what is due, but what has been actually received. The assets and liabilities may be measured by a different rule of accounting, but as said in one case,[18] "in the absence of any special law to the contrary, income must be taken to mean money, and not

company, made in pursuance to a state statute as "uncollected and deferred premiums" and "interest due and accrued," but no part of which had been received, were not a part of the company's "income received during such year." Speaking of the 1909 Law Justice Pitney said in Hays v. Gauley Mountain Coal Co., 247 U. S. 189: "The expression 'income received during such year' employed in the Act of 1909, looks to the time of realization rather than to the period of accruement." Accrued but unpaid interest on investments has been held not to be income. (Ins. Co. of North America v. McCoach, 218 Fed. 905.) In the 1913 Law the phrase "arising and accruing" was used. Doubtless it was the intention of Congress to employ terms of sufficient comprehension to reach actual income by foreclosing any possible avenue of escape, but it can hardly be said that in so doing an intention prevailed to tax that which did not actually exist, except on paper, as income accrued during the taxing period. (Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201. This case is No. 73 on the docket of the United States Supreme Court.) An early ruling of the Treasury Department, under the 1913 Law, holding that a person receiving fees or emoluments for professional services must report all actual receipts for services rendered in the year for which the return was made, together with all unpaid accounts, charges for services or contingent income due for that year, was discussed in Edwards v. Keith, 231 Fed. 110, in which the court said: "No such construction of the Treasury Department can enlarge the scope of the statute so as to impose the tax upon unpaid charges for professional services rendered, which for aught anyone can tell may never be paid. The statute alone determines what is income to be taxed. It taxes only income derived from many specified sources, and one does not derive income by rendering services and charging for them." In State ex rel. Moon Company v. Wisconsin Tax Commission, (Wis.), 163 N. W. 673, the court distinguishes between the case at bar and the case of Lynch v. Turrish, 247 U. S. 221, on the ground that the 1913 Federal Law taxed net income "*arising or accruing*" from all sources in the preceding calendar year, while the Wisconsin Law (§ 1087 (M) 1, Stat. 1911) taxed income *received*. The court said: "Unlike the Federal Act there is no need (under the Wisconsin Act) to ascertain whether the income arose or accrued in order to determine when it is taxable. The fact that it was received during 1911 makes it taxable irrespective of when it arose or accrued." In the 1916 Law the phrase "income received" was used with respect to both individuals and corporations. (Revenue Act of 1916, §§ 1 (a) and 10 (a).)

18 Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. This case is now No. 73 on the docket of the United States Supreme Court.

the expectation of receiving it or the right to receive it at a future time." Under the Revenue Act of 1918, with the exception of stock dividends, all items of gross income are required to be reported in the year in which they are received by the taxpayer, unless in order clearly to reflect income such amounts are to be accounted for as of a different period.[19] The Revenue Act of 1918 intends, therefore, primarily to tax individuals and corporations upon income received, and not income which has arisen or accrued, but has not been received.[20] This basis of actual receipts is not exclusively prescribed; for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. Net income is computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer unless no such method of accounting has been employed or the method employed does not clearly reflect the income, in which case the computation is made on such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.[21] Thus, individuals and corporations may report their income upon the basis of accruals instead of actual receipts. In other words, under the Revenue Act of 1918, the time as of which any item of income is to be accounted for is to be determined in the light of the fundamental rule that the computation of net income shall clearly reflect the taxpayer's income.[22] Unless the taxpayer keeps his books on a basis other than that of actual receipts, and reports accordingly, he should report as income all amounts received in the year in which payment is actually made.[23] The rules under the preceding laws are applicable under the 1918 law if the taxpayer keeps his books on the basis of actual receipts.[24] Thus, dividends and interest, professional fees of lawyers, physicians, and the like, need not be returned as income in the year in which they become due or are earned, but should be returned as income

19 Revenue Act of 1918, § 213 (a); Reg. 45, Art. 23.
20 Revenue Act of 1918, §§ 213 (a) and 233 (a).
21 Revenue Act of 1918, §§ 212 (b) and 232.
22 Reg. 45, Art. 22.
23 Reg. 45, Art. 23.
24 See one exception to this rule (Reg. 45, Art. 52).

in the year in which the payments are received.[25] Where the service and payment period is divided by the end of the taxable year, the compensation for the period so divided at the end of the year will be accounted for as income for the year in which payment is actually received. Where the service is compensated by fee, or is of such nature that no part of the fee or compensation becomes due until the completion of the service, the entire amount received should be income to be accounted for as of the year of receipt.[26] It is immaterial that the services for which payment may be made have been performed for a period extending over several years, the entire payment is taxable in the year in which received, and may not be pro-rated.[27]

Income Constructively Received. The rule that the law ordinarily taxes income "received" and not that which has "arisen or accrued" is subject to the qualification that income may be constructively as well as actually received. Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until the termination of five years of employment, the mere crediting on the books of the corporation does not constitute receipt.

[25] Letters from Treasury Department dated February 18, 1915, and March 1, 1915; I. T. S. 1919; ¶¶ 855 and 853.

[26] Reg. 33 Rev., Art. 4.

[27] T. D. 2135. In Edwards v. Keith, 231 Fed. 110, it was argued on behalf of an agent of a foreign insurance company, under a contract by the terms of which he should receive compensation on premiums of policies to the extent of certain specified percentages for a term aggregating twenty years from the date of each policy, that all of the labor creating such income had been performed prior to the incidence of the tax, but the court held that fact to be immaterial and sustained an assessment on the entire income for the year in which it was received.

The distinction between receipt and accrual must be kept in mind. Income may accrue to the taxpayer and yet not be subject to his demand or capable of being drawn on or against by him.[28] Appreciation in the value of property is not even an accrual of income to the taxpayer prior to the realization of such appreciation through conversion of the property.

EXAMPLES OF CONSTRUCTIVE RECEIPT. Where interest coupons have matured, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is so if the coupons are exchanged for other property instead of eventually being cashed. Dividends on corporate stock are subject to tax when set apart for the stockholder, although not yet collected by him. The distributive share of the profits of a partner in a partnership or of a stockholder in a personal service corporation is regarded as received. Interest credited on savings bank deposits, even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited.[29]

RECEIPT BY AGENT IS RECEIPT BY PRINCIPAL. A system of accounting adopted by an insurance company, which allowed a period of two months to local agencies in which to report their cash premium receipts to the home office, has been held, in view of the rules and regulations of the Commissioner, not to "clearly reflect" the company's income. A payment to the agent was held to be payment to the principal, and the company was required to include such payments in the return for the year in which they were received by the agent. The provision of the 1916 Law, permitting a corporation to report according to its books, was held not to justify the system followed by the corporation in this case, as the system adopted was required to be such as to "clearly reflect its income,"[30] and the provision[31] of the Revenue Act

[28] Reg. 45, Art. 53, Reg. 33 Rev., Art. 4; Letter from Treasury Department dated May 31, 1919; I. T. S. 1919, ¶ 3407.

[29] Reg. 45, Art. 54.

[30] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. This case is now No. 73 on the docket of the United States Supreme Court.

[31] Revenue Act of 1918, § 212 (b).

of 1918 that if the method of accounting regularly employed does not clearly reflect the income, the computation of net income shall be made upon such basis and in such manner as in the opinion of the Commissioner does "clearly reflect" income would seem to justify the same conclusion under the present law. The basis of this decision is undoubtedly that the cash premium receipts of the local agencies were constructively received by the home office when they were received by the local agencies.

INCOME FROM FOREIGN COUNTRIES. Where income has accrued in a foreign country on foreign investments but has not been remitted to the owner in this country, being placed to his credit in the foreign country, it has nevertheless been constructively received by the owner and he should report the same as income for the year in which it is placed to his credit, computing the amount in United States money by using the rate of exchange prevailing at the time the amounts were credited to him abroad.[32] If the owner receives a greater or less amount when the income is actually transmitted to him, owing to a fluctuation in exchange rates between the time when the income has been constructively received and the time when it is actually transmitted, it would seem that he should report the difference as income or claim it as a loss, as the case may be.[33]

Income Accrued. The Revenue Act of 1918 changes the privilege of reporting income upon the basis of book entries to a requirement that income be so reported. It is expressly provided that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of a taxpayer; if no such method of accounting has been so employed or if the method employed does not clearly reflect income the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.[34]

32 Letter from Treasury Department dated January 11, 1916; I. T. S. 1919, ¶ 1812.

33 See Chapter 25.

34 Revenue Act of 1918, § 212 (b); Reg. 45, Art. 22. See Chapter 33. The 1916 Law extended to taxpayers keeping their accounts upon a basis other than that of actual receipts and disbursements, unless such other basis did not clearly reflect the income, the *privilege* of making returns upon the basis upon which the accounts were kept. This privilege was subject, however, to regulations made by the Commissioner, limiting the right as the Commissioner saw fit. (Revenue Act of 1916, §§ 8 (g) and 13 (d). Taxpayers not keeping

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. The method of accounting will not, however, be regarded as clearly reflecting income, unless all items of gross income and all deductions are treated with reasonable consistency. The two systems cannot overlap; a taxpayer may not report in part on the accrual and in part on the basis of actual receipts.[35]

Income Received in Kind. When income is received in kind, as for instance, in produce, crops, or other property having no definite market value, no tax is assessable until the produce, crops or other property is disposed of, in which year such income is first reduced to money or a money equivalent.[36]

Income Received in the Equivalent of Cash. Items of income, as well as expenditures, need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation of net income, can be valued in terms of money.[37] The Revenue Act of 1918 expressly provides that stock

books in accordance with standard systems of accounting or in conformity with the requirements of some federal, state or municipal authority having supervision over the taxpayer were required to report their income on the basis of actual receipts and payments. (T. D. 2433.) In this ruling the Treasury Department placed certain limitations upon the extent to which reserves might be set up and deducted. While the language of the ruling refers particularly to corporations, there seems to be no reason why it should not be applicable to individuals as well.

35 Reg. 45, Art. 23; Maryland Casualty Company v. U. S., 52 Ct. Cls. 201. This case is now No. 73 on the docket of the United States Supreme Court.

36 Revenue Act of 1918, § 202 (b); T. D. 2153.

37 Reg. 45, Art. 22. It is held by the Treasury Department in a variety of cases that income (other than from dividends and from personal services) may be received in a form other than cash. Thus, where farm produce is exchanged for merchandise, groceries or mill products, the market value of the article or product received in exchange is to be returned as income (Reg. 45, Art. 38). *Rents* received in crop shares should be returned as income of the year in which the crop shares are reduced to money or a money equivalent. (Reg. 45, Art. 38.) When improvements made by a lessee become part of the real estate, the value of such improvements upon the expiration of the existing term of the lease is income to the lessor. (Reg. 45, Art. 48.) Warrants received by contractors pursuant to State contracts are considered income. (Reg. 45, Art. 37.) Promissory notes are held to be income to the extent of their discount or fair market value. (Reg. 45, Art. 34; Letter from Treasury Department dated March 1, 1916.) As stated broadly in Article 21 of Regulations 45, the term income "is not limited to cash alone, for the

dividends shall be considered income to the amount of the earnings or profits distributed and that amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.[38] It also expressly provides that "property" dividends shall be taxable.[39] Inventories and accounts receivable, may also be income-producing factors.[40] Salaries, wages or compensation for personal services of whatever kind "and in whatever form paid" are taxable income.[41] Any property having a market value is the equivalent of cash when received in exchange for other property.[42]

Income Received in the Form of Notes. Payments received in the form of promissory notes, not merely security for such payments, constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest,

statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion and accounts payable for expenses incurred." Again in Regulations 45, Art. 31, it is stated that "income may be received in the form of cash or of property." The case of Peabody v. Eisner, 247 U. S. 347, which recognized the doctrine that dividends received in the form of property (stock of corporations other than the distributing corporation) were taxable under the 1913 Law, which did not contain any express provision that "property" dividends should be taxable, settles the point that taxable income may be received in the form of *property*. The question still remains, however, how far the statute reaches out to tax "property" income; in other words, what is to be considered the "equivalent of cash." For purposes of "property" income, a line must be drawn somewhere between such readily convertible property as Liberty Bonds and such extremely unconvertible property as, for example, works of art. The question occurs in each case: Can the property received be turned to pecuniary account? The answer to this question must depend upon the peculiar facts of each case, and the character of the property received. (Smith v. Tennant (1892) A. C. 150, 66 L. T. 327, 3 Tax Cas. 158; U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas. No. 16, 228; U. S. v. Smith, 27 Fed. Cas No. 16, 341; State v. Frear, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164.)

38 Revenue Act of 1918, § 201 (c). But as to the taxability of stock dividends, see Chapter 19.

39 Revenue Act of 1918, § 201 (a).

40 Revenue Act of 1918, § 202 (a), 203; Reg. 45, Art. 21.

41 Revenue Act of 1918, § 213 (a).

42 Revenue Act of 1918, § 202.

may properly treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a six or seven per cent basis, the recipient may include such note in his gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted.[43]

Gross Receipts and Gross Income. It is important to note that the term "gross receipts" as ordinarily used is not synonymous with the term "gross income" for tax purposes. A taxpayer's gross income consists of his gross receipts less (a) receipts fundamentally free from tax, such as receipts constituting a return of capital, and (b) receipts representing the kind of income specifically exempted by the statute.[44] The Revenue Act of 1918 is the first income tax law to use the term "gross income," defining what is and what is not included therein, the latter being exempt income.[45]

[43] Reg. 45, Art. 34; Letter from Treasury Department dated March 1, 1915; I. T. S. 1919, ¶ 853. In the above letter it was held that notes received in settlement of an action or in payment of an indebtedness or of interest were to be considered as the equivalent of cash. In U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas. No. 16, 228, arising under the Civil War Income Tax Laws it was held that promissory notes taken in payment of a patent right were not income until the notes became due. The Court said: "In this case the defendant changes his patent rights for promissory notes payable in the future. Their value was uncertain; they might or might not be paid; but, until they were paid, they were not income, but only the ground of expecting income. The notes were no more taxable as income than would have been other patent rights, if the defendant had received them in payment of those he sold." On the other hand, in U. S. v. Smith, 27 Fed. Cas. No. 16,341, also arising under the Civil War Income Tax Laws, it was held that a transfer of stocks for a promissory note, which is collectible, or an exchange thereof for land, followed by a sale of such land within the year, for collectible promissory notes, is to be considered a sale of such stock for so much cash.

[44] Reg. 45, Arts. 21, 71.

[45] Revenue Act of 1918, §§ 213 and 235. Prior to the enactment of the Revenue Act of 1918 the Treasury regulations and rulings referred to "gross income" generally as the income of the taxpayer before making the deductions and allowances permitted by law. The 1916 Law did not use the phrase "gross income," but in prescribing the deductions allowed to corporations made use of the phrase "gross amount" of its income. (Revenue Act of 1916, § 12 (a).)

Exempt Income. In addition to income fundamentally free from tax the Revenue Act of 1918 specifically prescribes that certain income shall not be included in gross income and shall be exempt from tax. The intent seems to be that the income shall be exempt (with four exceptions) regardless of the status or character of the recipient.[46] The four exceptions are (a) the proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries[47] or to the estate of the insured (but not to corporations); (b) the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States; (c) income derived from any public utility, or the exercise of any essential governmental function and accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory or income accruing to the government of any possession of the United States, or any political subdivision thereof, and (d) so much of the amount received during the recent war by a person in the military or naval forces of the United States for active services in such forces, as does not exceed $3,500. The other provisions as to exempt income have no limitation with respect to the character or status of the recipient and the income would seem to be exempt whether received by an individual, a partnership or a corporation. Such income is as follows: (a) the amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of

[46] Revenue Act of 1918, §§ 213 (a) and 233 (a). Under the 1916 Law there were four exceptions such as are enumerated in the text, but they were different from the present exceptions. The four exceptions were (a) the proceeds of life insurance policies paid to *individual* beneficiaries upon the death of the insured; (b) compensation of the President of the United States; (c) compensation of the Federal Judges, and (d) compensation of officers and employees of a state or political subdivision thereof. (Revenue Act of 1916, § 4.) The income specified in (b), (c) and (d) seems now to be subject to tax, but the income specified in (d) has been held not to be taxable. (See chapter 15.)

[47] The Treasury Department has ruled that the term "individual beneficiaries" includes partnership beneficiaries. (Letter from Treasury Department dated November 18, 1919; I. T. S. 1919, ¶ 3644.)

the term mentioned in the contract or upon surrender of the contract, (b) the value of property acquired by gift, bequest, devise or descent (but the income from such property is taxable), (c) interest upon: (1) the obligations of a State, territory, or any political subdivision thereof, possessions of the United States, or the District of Columbia, (2) securities issued under the provisions of the Federal Farm Loan Act, (3) the obligations of the United States, issued prior to September 1, 1917, and if issued after such date, if and to the extent the acts authorizing the issue thereof, or acts supplementary thereto, exempt the interest from taxation to the taxpayer, both under the income and the war-profits and excess-profits taxes, (4) bonds issued by the War Finance Corporation if and to the extent stated in (3) above: (d) amounts received through accident or health insurance, or under Workmen's Compensation acts as compensation for personal injuries or sickness plus the amount of any damages received, whether by suit or agreement on account of such injuries or sickness, (e) income of any person derived from the operation of a public utility to be acquired, constructed, operated or maintained by such person, pursuant to a contract made with a State, territory or the District of Columbia, or any political subdivision of a State or territory prior to September 8, 1916, in excess of the part thereof to which such person is entitled under such contract.[48] A more complete discussion of exemptions of income is contained in the several chapters dealing with the respective kinds of income enumerated.

FEDERAL RESERVE BANKS. The income of Federal Reserve Bank is exempt from income tax[49] by express provision in the Federal Reserve Act.[50] The dividends on the stock of such banks are exempt from tax in the hands of member banks.[51] Divi-

[48] Revenue Act of 1918, §§ 213 and 233. Such tax-free income should not be included in the return of income and need not be mentioned in the return, unless information regarding it is specifically called for, as in the case, for example, of interest on municipal bonds. (Reg. 45, Art. 71.) Every person owning obligations, securities or bonds, the interest upon which is exempt, must submit a statement in his return showing the amount of such obligations, securities and bonds owned by him and the income received therefrom.

[49] Also from the excess-profits tax.

[50] Federal Reserve Act, 38 Stat. 251, Ch. 6, § 7.

[51] Reg. 45, Art. 75. Federal Reserve Bulletin, April 1, 1916.

dends paid by member banks are treated like dividends of ordinary corporations and are not exempt from tax.[52]

Net Income. "Net income" is defined by the Revenue Act of 1918 to be gross income as defined by the law less the statutory deductions.[53] Thus, taxable net income is wholly a statutory conception, although it follows, subject to certain modifications as to exemptions and as to some of the deductions, the lines of commercial usage. Statutory net income is, subject to these modifications, commercial "net income." This appears from the fact that ordinarily it is to be computed in accordance with the method regularly employed in keeping the books of a taxpayer.[54] Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year.[55]

Net Income Subject to Normal Tax. Net income, as defined in the preceding paragraph, is subject only to the surtax in the case of individuals and the excess-profits tax in the case of corporations. For the purpose of the normal tax in the case of individuals and the income tax in the case of corporations, certain additional deductions called "credits" are allowed.[56] These credits in the case of individuals are, (a) amounts received as dividends from a corporation which is taxable upon its net income or from a personal service corporation out of earnings or profits upon which income tax has been imposed; (b) the amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income; (c) the personal exemption; (d) the credit for dependents.[57] In the case of corporations the credits allowed are, (a) the amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income; (b) the amount of any excess profits tax imposed for the taxable year; (c) in the case of a domestic corporation, $2,000.[58]

52 Reg. 45, Art. 75; Reg. 33 Rev., Art. 86.

53 Revenue Act of 1918, §§ 212 (a) and 232 (a); Reg. 45, Art. 21.

54 Reg. 45, Art. 21.

55 Reg. 45, Art. 22.

56 Revenue Act of 1918, § 211 (b); Reg. 45, Art. 21.

57 Revenue Act of 1918, § 216 (a). Dividends are a deduction in the case of corporations. (Revenue Act of 1918, § 234 (a) 6.)

58 Revenue Act of 1916, § 236.

CHAPTER 15

INCOME FROM PERSONAL SERVICES

The law expressly provides that the gross income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in *whatever form paid,* or from professions or vocations.[1] It is to be noted that salaries, wages, or compensation for personal services are taxable income "in whatever form paid." Where services are paid for in something other than money, the fair market value of the thing taken in payment is income.[2] This is one of the three cases in which the law expressly specifies that the tax shall be based upon payments other than in cash, the others being the provision relating to dividends[3] and the provision relating to exchanges of property.[4]

Salaries. Salaries are ordinarily income of the year in which they are actually received and not necessarily in the year in which earned. They will be income of the year in which actually earned if the recipient keeps his accounts upon an accrued basis and reports accordingly. A salary paid by a corporation which is itself exempt from the income tax is nevertheless subject to tax in the hands of the employee.[5] In the case of corporations, so-called "salaries" of stockholders, if they are unreasonable in amount and if they bear a close relationship to the amount of stock held, are treated as a distribution of the net profits of the corporation, are not deductible as a business expense of the corporation, and are, therefore, not subject to the normal tax in the hands of the recipient. So-called salaries representing an appropriation of assets of the corporation by officers who control it and fix their compensation in violation of the

1 Revenue Act of 1918, § 213 (a).
2 Reg. 45, Art. 33.
3 Revenue Act of 1918, §§ 213 (a) and 201.
4 Revenue Act of 1918, § 202 (b).
5 T. D. 2135; T. D. 2090.

rights of the corporation are not deductible by the corporation insofar as they exceed a reasonable amount; such excessive payments are to be treated by their recipients, however, as compensation subject to the normal tax, since compensation illegally secured is none the less subject to tax in all respects. So-called salaries constituting in part payment for property, should, insofar as they exceed a reasonable amount, be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price. In the case of excessive payments by individuals or partnerships, the amounts of ostensible salaries disallowed as deductions should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the paying individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[6]

Bonuses and Profit Sharing. Where employees receive bonuses, or are entitled to a share of the profits of the employer the amount so received should be included as income, provided (a) it is clearly made as compensation for services rendered and (b) it is paid under a contract, express or implied, or a long-time practice (practically an implied contract) regularly employed, which constitutes a condition, if not a contract, under which the employees may reasonably expect additional pay for the greater or better services which they render, or (c) the total amount of salary and bonus is not greater than a reasonable compensation for the services rendered by the employee.[7] Such payments are income to the employee if they are of such character that the employer is entitled to deduct them as an expense of doing business. If a bonus is a mere gift, the employee should not treat it as income, since gifts or gratuities are not taxable, and the employer is not entitled to deduct it from his income as an expense of doing business. The rules governing the deduction of bonuses and profit sharing payments are more fully treated elsewhere in this book.[8] The rule to be followed by the employee is that if the employer is entitled to deduct the payments in question as an expense of doing business, the employee should

[6] Reg. 45, Art. 106; T. D. 2696. See Chapter 22.
[7] Reg. 45, Art. 107; T. D. 2696. See Chapter 22.
[8] See Chapter 22.

return them as income, and vice versa, if the employer is not entitled to deduct the payments in question as an expense the employee should not return them as income, otherwise the same sum of income would be taxed twice. If so-called bonuses or profit sharing paid to officers or stockholders of corporations, are in fact distributions of net profits bearing a close relationship to stock holding, or a waste or appropriation of the corporation's assets, or in part payment for property, they will be treated as indicated in the preceding paragraph. The same considerations apply when excessive bonuses are paid by individuals or partnerships.[9]

Commissions. Commissions paid salesmen, compensation for services on the basis of a percentage of profits, and commissions on insurance premiums are income to the recipients.[10]

Voluntary Offerings Received by Clergymen. Although as a general rule gifts and gratuities are not income, yet Easter offerings, and fees received by clergymen for funerals, masses, marriages, baptisms, and sums paid for saying masses for the dead, are considered income, because, though in the form of gifts, they are in fact payment to the clergymen, evangelists, and religious workers for services rendered.[11] Christmas gifts to clergymen do not come within this category.[12] The question is whether or not the money is actually a gift or merely in the form of a gift.

Tips. Tips, though in the form of gifts, are in fact payment for services rendered and constitute income to the recipient.[13]

Compensation Paid Other Than in Cash. Salaries, wages, or compensation for personal services are income "in whatever form paid." Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received.[14] Where there is no stipulation as

9 Reg. 45, Art. 106; T. D. 2696.

10 Reg. 45, Art. 32; T. D. 2090; Letter from Treasury Department dated April 30, 1918; I. T. S. 1919, ¶ 858.

11 Reg. 45, Art. 32.

12 T. D. 2090.

13 Reg. 45, Art. 32.

14 Reg. 45, Art. 33.

to the value of service, and payment for service is made with something other than money, the market or reasonable value of the thing taken in payment is the amount to be included as income.[15]

USE OF PROPERTY OF EMPLOYER. Where an employee uses his employer's property, horses, automobile, etc., by permission, and not by legal right as a part of his compensation for services, such use is in the nature of a gift from which no taxable income arises to the employee on the ground that he is receiving value for which he would otherwise have to pay.

LIVING QUARTERS, BOARD OR LODGING. When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employee, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax.[16]

15 Reg. 33 Rev., Art. 4.

16 Reg. 33 Rev., Art. 34; Reg. 45, Arts. 33, 292; T. D. 2090. This ruling would be applicable to any payment required by contract to be made in some form other than cash, but it does not necessarily mean that because an employee occupies, rent free, a house owned by the employer, he must return the rental value as income. If it was not stipulated in the contract of employment that such living quarters should be furnished as a part of the salary or wages, the privilege of occupying the house may be considered in the nature of a gift from which no taxable income arises. (T. D. 2135.) In this connection the case of Tennant v. Smith (1892) A. C. 150, 66 L. T. 327, 3 Tax Cas. 158, is interesting. It appeared in this case that the appellant Tennant was agent for a bank, and was bound as part of his duty to occupy the bank house as custodier of the whole premises belonging to the bank, and also for the transaction of any special bank business after bank hours. He was not entitled to sublet the bank house or use it for other than bank business, and in the event of his ceasing to hold his office he was under obligation to quit the premises forthwith. In holding that Tennant was not in receipt of any taxable income by reason of the use as living quarters of the bank house, the various Lords writing opinions freely conceded that such use might be a substantial benefit to Tennant. Lord Watson said: * * * "I do not think it comes within the category of profits, because that word, in its ordinary acceptation, appears to me to denote something acquired which the acquirer becomes possessed of and can dispose of to his advantage—in other words, money—*or that which can be turned to pecuniary account.*" Lord Macnaghten said: * * * "It is a tax on what 'comes in'—on actual receipts." * * * "No doubt if the appellant had to find lodgings for himself he might have to pay

TRAVELING EXPENSES. If an individual whose business requires him to travel receives a salary as full compensation for his services, without reimbursement of traveling expenses, his expenses for railroad fares, but not for meals and lodging, are deductible from gross income. If such an individual receives a salary and is also repaid his actual traveling expenses, no part of such expenses is deductible from gross income and no part of such repayment is returnable as income.[17]

INSURANCE PREMIUMS PAID FOR EMPLOYEES. Premiums paid by an employer on life, accident or health policies in favor of his employees as additional compensation of such employees are income to the employees.[18]

SERVICES IN CANCELLATION OF INDEBTEDNESS. If an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income.[19]

STOCK RECEIVED IN EXCHANGE FOR SERVICES. Compensation paid an employee of a corporation in its stock is, if the stock has a market value, to be treated as if the corporation sold the stock for its market value and paid the employee in cash.[20]

for them. His income goes further because he is relieved from that expense. But a person is chargeable for income tax under Schedule D, as well as under Schedule E, *not on what saves his pocket, but on what goes into his pocket.* And the benefit which the appellant derives from having a rent-free house provided for him by the bank, brings in nothing which can be reckoned up as a receipt or properly described as income.'' This case might, of course, be decided differently under the American law because compensation for personal services was involved and such compensation is taxable under the Revenue Act of 1918, ''in whatever form paid.'' (§ 213 (a).)

17 Reg. 45, Art. 291; T. D. 2079. See Chapter 21 for a full discussion of this subject.

18 Reg. 45, Art. 33.

19 Reg. 45, Art. 51.

20 Reg. 45, Art. 33. Conversely, in an early ruling of the Treasury Department under the 1913 Law it was held that commissions allowed salesmen paid in stock might be deducted as expense, if so charged on the books of the corporation, at the actual value of such stock. (Reg. 33, Art. 117.)

PROMISSORY NOTES RECEIVED IN EXCHANGE FOR SERVICES. Promissory notes received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value.[21]

Services Rendered Prior to March 1, 1913. Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim for compensation for such services and any interest which had then accrued. A claim for this purpose is a right existing unconditionally on March 1, 1913, and then assignable, whether presently payable or not. Interest does not, of course, include dividends on corporate stock.[22]

Compensation for Services Extending Over a Year. Where no determination of compensation is had until the completion of services, the amount received is income for the calendar year of its determination.[23] It was held under the 1916 Law that if no determination has been made of the amount due the trustee of an estate, as compensation for his services over a period of years, until the trust was terminated, the amount allowed him should be returned in full as income for that year, and it should not be pro-rated over the length of time the services were rendered.[24]

Compensation to Federal Government Officers and Employees Compensation received as such by officers and employees, whether elected or appointed, of the United States, or of Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia is subject to tax whether paid in cash or in other forms.[25] The entire sum received, however, is not necessarily taxable as will be indicated in the following paragraphs.[26]

LIVING QUARTERS. Commutation of quarters and the money equivalent of quarters furnished in kind should be returned as income. When quarters are furnished in kind of a less number

21 Reg. 45, Art. 34. See Chapter 14 for a discussion of the manner of computing the value of income received in the form of promissory notes.

22 Reg. 45, Art. 87.

23 Reg. 45, Art. 32; T. D. 2090; Letter from Treasury Department, dated April 30, 1918; I. T. S. 1919, ¶ 858. This point is more fully discussed in Chapter 14.

24 T. D. 2135.

25 Revenue Act of 1918, § 213 (a).

26 T. D. 2079.

of rooms than the number allowed by law, the money equivalent only of the number of rooms actually assigned should be returned as income. When quarters are furnished of a greater number of rooms than the number allowed by law, it is to be assumed that the excess number is assigned for the convenience of the Government, and the money equivalent only of the number of rooms allowed by law should be returned as income.[27]

Heat and Light. Amounts received by, or paid for, an officer for heat and light should be returned as income. This includes the money equivalent, as fixed by the Government, of heat and light furnished to an officer occupying public quarters.[28] Amounts expended for heat and light are in the nature of personal living expenses and differ in this respect from amounts furnished for mileage, the latter being in the nature of a business expense or an expense of the employer rather than that of the employee.

Mileage. Mileage, as such, is not income to an officer or employee, as he is required to pay his actual expenses while traveling under mileage orders. The excess, if any, of the amount received as mileage over the amount of actual necessary expenses incurred on a journey should, however, be returned as income. The actual expenses to be deducted by the individual before ascertaining his income on account of mileage are the expenses for which reimbursement would be made by the Government if he had traveled on an actual expense basis instead of a mileage basis.[29]

Reimbursement for Actual Expenses. Amounts paid by the Government in the nature of reimbursement for subsistence and other items of actual expense incurred while absent on business for the Government are not required to be returned as income.[30]

Per Diem Allowances. The total per diem allowance is income and there may be taken as a deduction for expense, the amount actually expended from such allowance for actual necessary traveling expenses.[31]

Compensation of Soldiers and Sailors. A person of either sex in active service in the military or naval forces may exclude from

27 T. D. 2079.
28 T. D. 2079.
29 T. D. 2079; Galm v. U. S., 39 Ct. Cls. 55.
30 T. D. 2079.
31 Reg. 33 Rev., Art. 8; T. D. 2079; T. D. 2124.

gross income his or her compensation received from the United States up to the amount of $3,500 in any taxable year, except that this exemption does not apply to compensation received either before or after the recent war. The date of the termination of the war for the purpose of the statute will be fixed by proclamation of the President. The military and naval forces of the United States include, among others, army contract surgeons. A person is in active service if he is actually serving in such forces, not necessarily in the field or in the theatre of war, and is not merely on the retired or reserve list. Accordingly, if such a person receives compensation from the United States of $3,500 or less and has no other income of an amount sufficient in itself to require him to render a return of income, he need make no return. Members of draft boards are not as such entitled to this exemption.[32]

Compensation of Federal Judges. The salaries of Judges of the Supreme Court and inferior courts of the United States, in office at the time the law was passed, were exempt from the tax, under the 1916 Law, but this did not include the salaries of such judges as were appointed subsequent to the passage of the law, or to retired judges.[33] The Revenue Act of 1918 expressly taxes the compensation of all federal judges.[34]

32 Reg. 45, Art. 86.

33 Revenue Act of 1916, § 4; T. D. 2090. This exemption was inserted in view of the provision of the Federal Constitution, Art. 3, § 1, which guarantees that the compensation of Federal judges shall not be diminished during their continuance in office. See Opinion of Justice Field in Pollock v. Farmers Loan & Trust Company, 157 U. S. 429; and 13 Op. Atty. Gen. 161. On February 16, 1863, Chief Justice Taney, of the United States Supreme Court, wrote a letter to Hon. S. P. Chase, then Secretary of the Treasury, vigorously protesting against the constitutionality of any construction of the income tax then in force as embracing a tax on salaries of the Judges of the Supreme Court. The Secretary of the Treasury, having ignored this letter, Chief Justice Taney procured its entry on the records of the Supreme Court on March 10, 1863 (Tyler's Life of Taney, pp. 432, 435). It was deemed unpatriotic to resist the collection of the tax, at least during the war and it was collected until toward the end of 1869 when the opinion of the Attorney-General referred to above was rendered, advising against the constitutionality of any tax upon the salary of the President of the United States and upon the Judges of the Supreme Court. An interesting question is presented as to how this question of constitutionality can be determined with propriety, since the judges of the courts which have jurisdiction of the question also have an interest therein. (See State ex rel Wickham v. Nygaard, 159 Wis. 396; 150 N. W. 513.)

34 Revenue Act of 1918, § 213 (a).

Compensation of the President of the United States. Under the 1916 Law, the compensation of the President of the United States in office at the time the law was passed was exempt from the tax during the term for which he was elected.[35] Compensation received as such by the President of the United States is expressly taxable under the 1918 Law.[36]

Compensation of Officers and Employees of a State or Political Subdivision Thereof. The Revenue Act of 1918, does not expressly exempt "the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government," as did the 1916 Law.[37] It would seem, therefore, that such compensation is intended to be made taxable,[38] but the Treasury Depart-

[35] Revenue Act of 1916, § 4. In an opinion of the Attorney-General in 1869 it was held that a specific tax by the United States upon the salary of the President in office at the time the act was passed, to be deducted from the salary which otherwise would be paid him, would be a diminution of his compensation in contravention of Article 2, § 1, Clause 7, of the Federal Constitution, which provides that the compensation of the President shall neither be increased nor diminished during the period for which he shall have been elected. 13 Op. Atty. Gen. 162. This consideration no doubt moved Congress to grant the exemption in the 1916 Law.

[36] Revenue Act of 1918, § 213 (a). As the President's salary is now taxable the interesting question is presented whether or not the expenses incurred by him in entertaining diplomatic and other guests of the government will be considered to be personal, living and family expenses, to be covered by the $2,000 personal exemption, or will be deductible.

[37] Revenue Act of 1916, § 4.

[38] The general opinion that a federal tax on the salaries of officers or employees of a State is unconstitutional, is based on the cases, among others, of Collector v. Day, 11 Wall. 113; Freedman v. Sigel, 9 Fed. Cas. No. 5,080; U. S. v. Ritchie, 27 Fed. Cas. No 16,168. In the Day case, Day, who was Judge of the Court of Probate and Insolvency for a county in Massachusetts, was taxed on his salary in 1866 and 1867 as such officer. The question was presented "whether or not it is competent for Congress, under the Constitution of the United States, to impose a tax upon the salary of a judicial officer of a State." The court considers at some length the case of Dobbins v. Erie Co., 16 Pet. 435, in which it was decided that a State could not levy a tax on the salary of an officer of the United States, because (1) such officer was a means or instrumentality employed for carrying into effect some of the legitimate powers of the Federal Government which could not be interfered with by the States, (2) the salary or compensation for the service of the officer was inseparably connected with the office, and (3) if the officer was exempt, his salary was equally exempt. The court also considered at some length the

ment has ruled that compensation paid its officers and employees by a State or political subdivision thereof, including fees received by notaries public commissioned by States and the commissions of receivers appointed by State courts, are not taxable. Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable income the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the Act of March 2, 1887, relating to agricultural experiment stations in such colleges.[39] The compensation paid by a municipality to a "special counsel" is taxable income.[40] The exemption under the 1916 Law applied to officers and employees of the state and of its counties, municipalities, townships and other political subdivisions. The salaries of public school teachers came within this class.[41] An individual who entered into a con-

leading case of McCullough v. Maryland, 4 Wheat. 316, and discussed the relationship between the Federal Government and the separate States. Conceding that the exemption of the salaries in question from income tax rested upon "necessary implication," the court placed its decision on the grounds that (1) in respect to the powers reserved to them, one of which was the power to maintain a judicial department, the separate States are as sovereign and independent as the Federal Government, (2) that the unimpaired existence of such reserved powers is as essential in one case as in the other, and (3) the means and instrumentalities employed by the States for carrying on the operations of their governments, for preserving their existence and for fulfilling the duties assigned to them by the Constitution, must be left free and unimpaired and must not be crippled or defeated by another taxing power. Opinion to the contrary is founded largely upon the recent cases of Peck v. Lowe, 247 U. S. 165, and U. S. Glue Co. v. Oak Creek, 247 U. S. 321. The bill as introduced into Congress expressly taxed such salaries, but the provision was stricken out in the Senate, and not restored by the Conference Committee, although that committee restored the provision taxing the salary of the President and salaries of federal judges. Under the Canadian form of government, it has been held that a Provincial legislature has power to tax the official income of an officer of the Dominion Government. (Abbott v. St. John, 40 Can. Sup. Ct. 597; Webb v. Outrin, (1907) App. Cas. 81; contra the discredited case of Leprohon v. Ottawa, 2 Ont. App. 522.

39 Reg. 45, Art. 85. Letter from Treasury Department dated May 17, 1919; I. T. S. 1919, ¶ 3335.

40 Letter from Treasury Department dated April 15, 1919; I. T. S. 1919, ¶ 3313.

41 Reg. 33, Art. 5.

tract with a state, or any political subdivision thereof, for the doing of a thing or things specified by the contract, the completion of which would constitute a fulfillment of the contract on the part of such individual, was held not to be an officer or employee of the State or political subdivision thereof, and the amount received by him from the State or political subdivision thereof under the terms of the contract was required to be accounted for as income.[42] The exemption did not include an individual who entered into a contract with a State for the construction of public works, as such person is neither an officer nor an employee.[43] It was also ruled that where a real estate corporation was employed by a city to appraise the value of property, it could not claim exemption as an employee. Officials of the governments of the District of Columbia, Porto Rico and the Philippine Islands, or the political subdivisions thereof, did not come within this class under the 1916 Law and the compensation paid to them was not exempt.[44]

[42] Reg. 33 Rev., Art. 4.
[43] T. D. 2152. See Revenue Act of 1918, § 213 (a) (7).
[44] Revenue Act of 1916, § 23.

CHAPTER 16

INCOME FROM BUSINESS, TRADE OR COMMERCE

The Revenue Act of 1918 provides that gains, profits and income derived from trades, businesses or commerce, or the transaction of any business carried on for gain or profit,[1] shall be taxable. The general rules respecting income from such sources are discussed in this chapter, and the reflection of income by means of inventories.[2] The subjects of income derived from sales or dealings in property, and income from interest, rent and royalties are discussed in other chapters.[3]

Gross Income from Business. In the case of a manufacturing, merchandising or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses or losses, or for items not ordinarily used in computing the cost of goods sold. Gross income includes all amounts received by the taxpayer as allowances for amortization, from whatever source and by whatever name called. The allowance for amortization authorized by the statute must be taken by way of explicit deduction from gross income.[4]

Income of Contractors. Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction

1 Revenue Act of 1918, § 213 (a).

2 See Chapter 25 for discussion of the subject of losses in inventories.

3 See Chapters 17 and 18.

4 Reg. 45, Art. 35; Reg. 33 Rev., Art. 93; Reg. 33, Arts. 106 and 107.

from gross income should be limited to the expenditures made on account of such completed contracts. Or the percentage of profit from the contract may be estimated on the basis of percenage of completion, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year. Upon the completion of a contract if it is found that as a result of such estimate or apportionment the income of any year or years has been overstated or understated, the taxpayer should file amended returns for such year or years.[5]

Income from Export Business. Under the 1916 Law income from the business of exporting goods was held by the Treasury Department to be taxable. It has also been held that a tax on such income is not a tax on the articles exported, and therefore not unconstitutional in that regard, since if Congress has power to lay a tax up to the time when articles are put in course of exportation, the conclusion is unavoidable that the net income arising from exportation when it has been completed or after the exportation and sale are fully consummated, is likewise subject to taxation under general laws.[6]

Discounts. The discount allowed to a corporation purchasing new equipment need not be reported as income, but the cost of the equipment as charged to capital must represent only the net cost after making allowance for the discount in question.[7]

Bank Discounts. In cases wherein banks or other corporations loan money by discounting bills or notes, one of two methods is used in determining the amount of discount to be reported as income, namely: (1) if the bank or corporation makes a practice of crediting such discount directly to a "discount account" or to profit and loss, the total amount thus credited during the year should be considered income and should be so reported, regardless of the fact that a portion of this amount may represent discount paid in advance and not then earned; (2) if the bank or

5 Reg. 45, Art. 36; Reg. 33 Rev., Art. 121; T. D. 2161.

6 Peck v. Lowe, 247 U. S. 165.

7 Letter from Treasury Department dated November 26, 1918; I. T. S. 1919, ¶ 1827.

corporation follows the practice of crediting such discount to an "unearned discount account," and later, as the discount becomes earned, debits the unearned account and credits an "earned discount account" with the amount so earned, the total amount credited to the "earned discount account" during the year should be considered income and should be so reported. The corporation reporting income of this character should state in a memorandum attached to its return which of the two methods was used in determining the amount of discount returned.[8] The latter of the two above methods has been generally recognized as the correct method of computing such income and the Comptroller of the Currency has suggested the adoption of this method by all national banks. In a case where the method of handling discount and interest on time loans was changed on January 1, 1918 from the former to the latter of the two above methods the Treasury Department ruled that amended returns should be filed showing the correct amount of income back to the year 1909 inclusive, or to the date of the bank's organization, if organized subsequent to 1909.[9]

Inventory. Taxpayers engaged in manufacturing or mercantile business usually determine their net income by inventory, purchases during the year plus the stock on hand at the beginning of the year, being subtracted from sales during the year plus stock on hand at the close of the year, or vice versa, to ascertain the gain or loss. The Treasury Department's first recognition of this system required that in every case where the annual gain or loss was determined by inventory, the merchandise must be inventoried at cost price, as any loss in salable value would ultimately be reflected in the sales during the year when the goods were disposed of. This rule permitting inventories on the basis of cost only was later altered and new rules established for the purpose of income and excess-profits tax returns, permitting inventories at cost or market value, whichever is lower.[10] Except where inventories are allowed at cost or market, gain or loss must in all

8 Reg. 33 Rev., Art. 114.

9 Letter from Treasury Department dated February 11, 1919; I. T. S. 1919, ¶ 3248.

10 T. D. 2609. The Attorney-General has advised on the authority of Doyle v. Mitchell Brothers, 247 U. S. 179, that the methods of taking inventories authorized by T. D. 2609 are permissible. (T. D. 2744; T. D. 2649.)

cases be determined on the basis of cost or of value as of March 1, 1913.[11] In no cases should overhead charges be included in inventory.[12] It is provided by the Revenue Act of 1918 that whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner with the approval of the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income,[13] and gain or loss is determined in the case of property acquired on or after March 1, 1913, on the basis of the cost thereof or inventory value, if the inventory is made in accordance with the above provision.[14]

NEED OF INVENTORIES. In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes, together with all finished or partly finished goods. Title to the merchandise included in the inventory should be vested in the taxpayer and goods merely ordered for future delivery and for which no transfer of title has been effected should be excluded. The inventory should include merchandise sold but not shipped to the customer at the date of the inventory, together with any merchandise out upon consignment, but if such goods have been included in the sales of the taxable year they should not be taken in the inventory. It should also include merchandise purchased, although not actually received, title to which has passed to the purchaser. In this regard care should be exercised to take into the accounts all invoices or other charges in respect of merchandise properly included in the inventory, but which is in transit or for other reasons has not been reduced to physical possession.[15]

11 T D. 2609.

12 See instructions on back of Form 1031 for 1916.

13 Revenue Act of 1918, § 203.

14 Revenue Act of 1918, § 202 (a) 2. Copies of inventory need not be filed with the return, but it is recommended that the taxpayer attach to his return a summarized analysis of his inventories. (I. T. S. 1919, ¶ 3958.)

15 Reg. 45, Arts. 24, 1581; T. D. 2609.

VALUATION OF INVENTORIES. Inventories should be valued at (a) cost or (b) cost or market, whichever is lower. Whichever basis is adopted must be applied to each item and not merely to the total of the inventory; that is, if for instance basis (b) is adopted, the value of each item in the inventory will be measured by market if that is lower than cost, or by cost if that is lower than market. A taxpayer may, regardless of his past practice, adopt the basis of cost or market, whichever is lower, for his 1918 inventory, provided a disclosure of the fact and that it represents a change is made in the return. Thereafter changes can be made only after permission is secured from the Commissioner. Inventories should be recorded in a legible manner and properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased.[16]

INVENTORIES AT COST. Cost means: (1) In the case of merchandise purchased, the invoice price less trade or other discounts except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods; (2) In the case of merchandise produced by the taxpayer, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital whether by way of interest or profit. In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.[17]

INVENTORIES AT MARKET. Market means the current bid price prevailing at the date of the inventory for the particular mer-

16 Reg. 45, Art. 1582.
17 Reg. 45, Art. 1583.

chandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory. Where no open market quotations are available the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available to him, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. The burden of proof will rest upon the taxpayer in each case to satisfy the Commissioner of the correctness of the prices adopted. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market has been established during the succeeding year, a claim may be filed for any loss sustained.[18]

INVENTORIES BY DEALERS IN SECURITIES. A dealer in securities, who in his books of account regularly inventories unsold securities on hand either (a) at cost or (b) at cost or market whichever is lower, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers, that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment.[19] A bank or other in-

18 Reg. 45, Art. 1584.
19 Reg. 45, Art. 1585.

stitution having a regularly established department for the merchandising of securities, even though that department is subordinate in importance to other departments, is entitled to the same benefit of using the basis above provided of inventorying securities acquired and held for resale, as one who is solely a dealer in securities. In so far as the bank or other institution carries on, with an established place of business, a department for the merchandising of securities, it is in respect of such department treated in the same way as any other security merchant.[20] Taxpayers who buy and sell or hold securities for investment or speculation, and not in the course of an established business, and officers of corporations and members of partnerships, who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.[21]

20 Letter from Treasury Department dated June 28, 1919; I. T. S. 1919, ¶ 3473.

21 Reg. 45, Art. 1585.

CHAPTER 17

INCOME FROM SALES OR DEALINGS IN PROPERTY—QUASI-CAPITAL TRANSACTIONS

The law expressly provides that gains, profits and income derived from sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property, shall be taxable.[1] It has been argued that gains resulting from an increase in capital should not be taxed in cases where an owner was not engaged in the business of dealing in such property, but the broad language of the Revenue Act of 1918 indicates that Congress intended the tax to apply to all transactions whether or not the taxpayer is a dealer, and the Treasury Department has so held.[2] A leading case [3] construing the income

1 Revenue Act of 1918, § 213 (a).

2 In Doyle v. Mitchell Brothers, 247 U. S. 179, decided under the 1909 Law, the Court said: "Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.'" Although the plaintiff in this case was not a real estate trading corporation the court proceeded on the assumption that certain of the proceeds of a conversion of stumpage lands should be treated as income, the difficult question at issue being to differentiate between the capital and income of such proceeds. In Hays v. Gauley Mountain Coal Co., 247 U. S. 189, although the plaintiff was not engaged in the business of trading in stocks and did not have such business among its corporate powers, the court held that so much of the profits from a sale of certain stock as might be deemed to have accrued subsequent to December 31, 1908, must be treated as gross income. See also U. S. v. Cleveland etc. Ry. Co., 247 U. S. 195. These cases, however, construed the 1909 Law, which was not an income tax law, but a law imposing an excise tax. T. D. 2090; T. D. 2137; see Trefry v. Putnam (Mass.), 116 N. E. 904.

3 Gray v. Darlington, 15 Wall. 63. This case is in apparent conflict with the earlier lower court case of U. S. v. Smith, 1 Sawy. 277, 27 Fed. Cas. No. 16,341, in which it was held, over the objection that annual gains meant only the appreciation or increase in the value for the year in which a sale occurs, that annual gains upon a sale of corporate stock meant all gains realized in a given year, although they had been accumulating by the increase in value

tax act of 1864 held that the gain to an individual resulting from the sale of property, purchased by him several years before, was not taxable, on the theory that the increased value of the property could not be said to be gain in any particular year of the time during which it was held.[4] It has been argued that the rule laid down in this case should be applied to the present law, but the language of the statute under which the case was decided differs considerably from the language of the 1909, 1913, 1916 and 1918 Laws and it is not certain whether such a rule would be applied to the construction of the present statute.

Basis for Determining Gain or Loss from Sale. For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior thereto, or (b), if acquired on or after that date, its cost or its approved inventory value. The gain, profit or income derived from sales or dealings in property is the amount by which the selling price of the property exceeds such fair market price or value, cost or approved inventory value.[5]

SALE OF PROPERTY ACQUIRED BY GIFT OR BEQUEST. In the case of property acquired by gift, bequest, devise or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto. For the purpose of determining the profit or loss from the sale of property acquired by bequest, devise or descent since February 28, 1913, its value as appraised for the purpose of the Federal estate tax, or in the case of estates not subject to that tax its value as appraised in the State court

of the stock for many years following the enactment of the law taxing annual gains.

4 It is stated by Mr. Justice McKenna in Lynch v. Turrish, 247 U. S. 221, that the case of Gray v. Darlington decided that such an advance in value is not income at all, but merely increase of capital and not subject to tax as income. See Scott v. Schwab, 255 Fed. 57.

5 Reg. 45, Art. 1561; Revenue Act of 1918, § 202 (a). The above provision establishing the fair market price or value as of March 1, 1913, as a basis in the case of property acquired prior to that date first appeared in the 1916 Law, no reference being made in the 1909 Law or the 1913 Law as to assets acquired prior to the incidence of the tax.

for the purpose of State inheritance taxes, should be deemed to be its fair market value when acquired.[6]

PROFIT NOT BASED ON BOOK VALUES. The value at which property is carried on the books of the owner is not conclusive evidence of its actual value. Where the Government attempts to impose a tax upon the difference between the book value and selling price, the taxpayer may show by other evidence the actual cost thereof or the actual value at the incidence of the tax.[7]

Fair Market Price or Value as of March 1, 1913. When property sold was acquired prior to March 1, 1913, its original cost is disregarded as a basis for any gain derived or loss sustained and the value as of March 1, 1913, is taken, whether such value is more or less than the original cost. What the fair market price or value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear.[8] The value of the tangible and

[6] Reg. 45, Art. 1562.

[7] See Doyle v. Mitchell Brothers, 247 U. S. 179; U. S. v. Guggenheim Exploration Co., 238 Fed. 231; Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704, upon the question of the weight to be attached to book entries. Under the provisions of the 1909 Law the Treasury Department permitted income to be computed on the basis of changes in book values. Hence, where a corporation for the years 1909 to 1912 inclusive, made its returns strictly in accord with the regulations then in force, the increase of book values of property being returned as income and corresponding decreases being deducted, the profit on the sale of such property could be computed under the 1913 Law by deducting the last adjusted value subsequent to January 1, 1909, without pro-rating, as required in other cases. (T. D. 2130.) This ruling has no application under either the 1916 Law, or the Revenue Act of 1918, which expressly requires, in all cases, that the gain be based on the value as of March 1, 1913, regardless of any book values prior thereto.

[8] Reg. 45, Art. 1561. Under the 1909 and 1913 Laws it was the practice of the Department to require the taxable profit to be determined by first ascertaining the difference between the cost and the selling price and then pro rating the result according to the number of months the property was held before and after the incidence of the tax, but this rule has no application under the present laws, except as a last resort when the value as of March 1, 1913, cannot be found by other means. In Doyle v. Mitchell, 247 U. S. 179, no question was raised as to whether, in apportioning the profits derived from a distribution of capital assets acquired before and converted after the incidence of the tax, the division should be pro rata according to the time elapsed, or should be based upon an inventory taken as of the day before the incidence of the tax. The latter method was adopted and the government made no contention as to the accuracy of the result thereby reached. In Hays

intangible assets of a corporation, inclusive of the value of good will, as of March 1, 1913, is to be taken into consideration, together with such other facts as may be necessary, where it is desired to establish the market value of its outstanding capital stock on March 1, 1913, for income tax purposes.[9]

SHARES OF SAME STOCK BOUGHT AT DIFFERENT PRICES. When various parcels of stock of the same issue are bought and sold on different dates and at different prices, the shares sold should be identified, if possible, by the numbers of the certificates covering them, and the cost of the identical shares should be deducted in order to determine the profit. Where it is impossible to identify the shares in this manner, the shares should be considered to be sold in the order in which they were purchased, that is, the cost of the first shares purchased should be deducted from the selling price of the first shares sold.[10]

MARKET VALUE OF SECURITIES ON MARCH 1, 1913. Where stock, acquired prior to March 1, 1913, is sold, and such stock was traded in on an exchange, the fair market price or value as of March 1, 1913, is held to be the average price for the day in cases where there is a variation between the opening and closing price.[11]

Cost of Property. The cost of property is the actual price paid for it when acquired, together with (a) the expense of acquiring it, (b) the expense of selling it, (c) the cost of any improvements or betterments which have been made with respect to the property,[12] and (d) carrying charges, provided they have been capitalized and have not been deducted in any annual return of the owner filed subsequent to the incidence of the income tax.[13]

v. Gauley Mountain Coal Co. 247 U. S. 189, the court referred to the method employed as a matter of detail, to be settled according to the best evidence obtainable and in accordance with valid departmental regulations, and in the case at bar, involving a sale of securities, there being no evidence of inventory value, a prorating method was adopted. In U. S. v. Cleveland etc. Railway Co., 247 U. S. 195, the market value of stock on the last day before the incidence of the tax was taken as a measure of capital assets. (See T. D. 2740.)

9 Letter from Treasury Department dated July 22, 1919; I. T. S. 1919, ¶ 3506.

10 Reg. 45, Art. 39; Letter from Treasury Department dated February 26, 1916; I. T. S. 1918, ¶¶ 413 and 1343; Reg. 45, Art. 36.

11 Letter from Treasury Department dated November 21, 1916; I. T. S. 1919, ¶ 1857.

12 T. D. 2090.

13 T. D. 2137.

Interest should not be added to the purchase price in order to ascertain cost,[14] and cost must be reduced by the amount of any depreciation or depletion sustained since February 28, 1913.[15]

Selling Price. A sale of property usually involves the payment of cash in whole or in part therefor, and in so far as payment is received by the vendor in cash no special difficulty arises in determining the amount of his gains, profits or income. The statute, however, taxes income from dealings in property as well as sales thereof, and reaches transactions such as exchanges of property, which in effect may be sales for a consideration in the equivalent of cash.[16] In a sense, property received in exchange for other property constitutes a selling price other than cash, and in such cases the determination of the amount thereof and the gains, profits or income of the vendor, if any, presents the difficulties discussed in the following paragraphs.

Exchanges of Property. Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income

14 Hays v. Gauley Mountain Coal Co., 247 U. S. 189. In this case the court said: "That the sale resulted in a gain or profit to the extent of $210,000, the difference between the buying and selling prices, is not to be doubted, for there is no merit in the contention that interest should be added to the purchase price in order to ascertain its cost. The money that went into the purchase was not loaned at interest; on the contrary, by the very fact of the purchase it was placed where it could not earn interest for the respondent in the ordinary sense, and the gain represented by the increase of selling price over cost price must be regarded as a substitute for whatever return some other form of investment might have yielded." The court refused to pass on this question in State ex rel. Bundy v. Nygaard (Wis.), 158 N. W. 87.

15 Reg. 45, Art. 1561.

16 For a discussion of income in the equivalent of cash, see Chapter 14.

is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty Bond, income may be realized, because the conversion is into independent property having a market value. The property received in exchange of a so-called convertible bond for stock pursuant to such a privilege granted in the bond will produce income if the stock received in exchange has a fair market value in excess of the cost or fair market value as of March 1, 1913, of the bond.[17]

Determination of Gain or Loss from Exchange of Property. The amount of income derived in the case of an exchange of property, as of stock for a bond, is the excess of the fair market value at the time of exchange of the bond received in exchange over the original cost of the stock exchanged for it, or over the fair market price or value of such stock as of March 1, 1913, if acquired before that date. The amount of income derived from a subsequent sale of the bond for cash is the excess of the amount so received over the fair market value of such bond when acquired in exchange for the stock. On the other hand, if the property received in exchange is substantially the same property or has no market value, then no gain or loss is realized, but the new property is to be regarded as substituted for the old and upon a sale of the new property the amount of income derived

17 Reg. 45, Art. 1563; Letter from Treasury Department dated August 3, 1917; I. T. S. 1918, ¶ 1308. The above ruling (Reg. 45, Art. 1563) especially the illustration of the closely held corporation is to be considered in connection with and as limited by T. D. 2924. See notes 24 and 29. It seems to be a fairer and more justifiable construction of the statute than the Treasury Department's later ruling. In U. S. v. Smith, 27 Fed. Cas. No. 16,341, it was held that when property is exchanged or bartered for other property, neither having a fixed or determinable money value, and the exchange is not made on the basis of money value, no taxable income arises from the transaction. Thus, an exchange of one horse for another horse, does not create taxable gain to either party to the transaction though each may feel convinced he is the richer by the deal. If either party subsequently sells the horse received by him in the exchange, his profit will then be the difference between the selling price of that horse and the cost to him of the horse he first owned. It was said in the district court in Sargent Land Co. v. Von Baumbach, 207 Fed. 423, affirmed 219 Fed. 31, reversed 242 U. S. 503, "The mere change *of form* of ownership from that of these individuals to that of a corporation owned by the same individuals cannot produce such large profits as are claimed here."

is the excess of the amount so received over the cost or fair market value as of March 1, 1913, of the old.[18]

Exchange for Different Kinds of Property. If property is exchanged for two different kinds of property, such as bonds and stock, the bonds having a market value and the stock none, the value of the bonds is to be compared with the cost or fair market value as of March 1, 1913, of the original property, as the case may be. If the market value of the bonds is less than such cost or value, the difference represents the cost of the stock. If the market value of the bonds is greater than such cost or value, the difference is taxable income at the time of the exchange and whenever sold the entire proceeds of the stock will be taxable. If property is exchanged for two different kinds of property, such as bonds and stock, neither having a market value, the cost or fair market value as of March 1, 1913, of the original property should be apportioned, if possible, between the bonds and stock for the purpose of determining gain or loss on subsequent sales. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the bonds or stock is realized until out of the proceeds of sales shall have been recovered the entire cost or fair market value as of March 1, 1913, of the original property.[19]

Reorganization, Merger, Consolidation and Dissolution of Corporations. When property is exchanged for other property, the property received in exchange is to be treated for the purpose

18 Reg. 45, Art. 1564. See, however, T. D. 2924, amending Reg. 45, Arts. 1566 and 1567 and notes 17, 24 and 29. Where a broker induces a customer to change his investments, on the basis of market prices at a certain time, the difference in prices being adjusted by a cash payment, such a transaction is one in which each party is able to compute in money values his gain or loss. Thus, as an illustration, Jones may have purchased a bond for $900, and Smith may have purchased ten shares of stock for $850. The market for each investment having gone up ten points, Jones and Smith exchange investments, Smith paying $50 additional in cash. As a result, Jones is in possession of stock having a market value of $950 and $50 in cash, while Smith has a bond with a market value of $1,000, but his amount of cash is reduced by $50. Upon analysis it is seen that the transaction is in fact a double one, equivalent to each party having paid the other in cash the full market value of the security, and having purchased from the other, for cash, a new security. Each has clearly realized a gain of $100 and, with respect to each, the transaction is a closed and completed one. Each should report income of $100.

19 Reg. 45, Art. 1565.

of determining gain or loss as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss is deemed to occur from the exchange, and the new stock or securities received are treated as taking the place of the stock, securities, or property exchanged. When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received is treated as taking the value of the stock or securities exchanged, and the amount of the excess in par or face value is treated as a gain to the extent that *the fair market value* of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.[20] Amounts distributed in the liquidation of a corpora-

[20] Revenue Act of 1918, § 202 (b). Prior to the enactment of these provisions the rulings upon this subject were obscure and inconsistent. The original rulings were to the effect that upon a reorganization, where a new corporation was formed with a larger par value, the transfer of the assets from the old to the new and the exchange of stock by the stockholders of the old for a greater par value of stock of the new, did not create taxable income. (Letter from Treasury Deparment dated May 3, 1915; I. T. S. 1918, ¶ 1292; Letter from Treasury Department dated April 1, 1915; I. T. S. 1918, ¶ 398.) In the latter ruling it was said: "In this transaction there is nothing to indicate that the two shares of stock in the B. Company of a par value of $100 each, had a value in cash or its equivalent in excess of the value of the stock in the A Company. There is no evidence other than the difference in the quantitative par value of the shares of stock, that any gain, profit or income was realized from the exchange of the shares of stock. It is, therefore, the opinion of this office that no accounting of income will be required until such time as the individual in question sells the stock of the B Company at a price in excess of the capital which he originally invested in the stock of the A Company." Where, upon a reorganization, new stock was acquired by a stockholder in exchange for old stock, and both were of the *same par value*, no income arose at the time of the exchange, but when the new stock was sold, the gain was required to be based upon the cost of the old stock, or its value as of March 1, 1913. (Letter from Treasury Department dated March 8, 1917; I. T. S. 1918, ¶ 1302.) Where upon a reorganization stock of the new company was issued in exchange for shares of the old, the new company

tion are treated as payments in exchange for stock or shares,

taking over the property of the old, no income accrued if the exchange of stock was share for share of like par value, even though the property of the first corporation had increased in value over a period of years since its stock was first issued. Where the stock of both corporations was of like par value and predicated upon exactly the same assets the transaction resulted in no gains, profits or income to either the first corporation or its stockholders. If the stock of the first company at the time of the transaction was worth "double par," the stock of the second company, being supported by identically the same assets, was presumably of the same value, and the exchange of the new stock for the old resulted in no income. It was simply an exchange of assets of like character and like value. (Letter from Treasury Department dated March 8, 1917; I. T. S. 1918, ¶ 1302.) Where the assets of one corporation were transferred to another, the stockholders of the first receiving in exchange for their stock *a greater amount of stock*, par value, in the new corporation, the *par value* of the new stock was considered as the equivalent of cash and taxable to the extent that it exceeded the cost of the old. Where the stockholders of a corporation surrendered their stock for stock of less par value, they were permitted to claim a loss on the difference between the cost of the old and the par of the new. (Letter from Treasury Department, dated March 9, 1917; I. T. S. 1918, ¶ 3222.) In later rulings, however, it was held that, upon a reorganization, where a new corporation was formed with a stock of larger par value, the transfer of assets of the old to the new and the exchange of stock by the stockholders of the old for stock of a greater par value of the new, created income to the old corporation and its stockholders; but that in determining the amount of such income, or the "amount received" by the old corporation and the "amount distributed" to its stockholders, the par value of the stock of the new corporation would only be taken as the actual value, or an equivalent of cash, "in the absence of any proof to the contrary." In other words, although the transaction was still held to be a closed and completed one, the conclusive presumption, that the par value of the stock of the new corporation represented actual value and was the equivalent of cash, was reduced to a rebuttable presumption; and the value of such stock became a matter of proof, or question of fact. (Letter from Treasury Department dated November 10, 1917; I. T. S. 1918, ¶ 1309; letter from Treasury Department dated December 8, 1917; I. T. S. 1918, ¶ 1313; letter from Treasury Department dated March 19, 1918; I. T. S. 1918, ¶ 3222; Reg. 33 Rev., Art. 101.) The Treasury Department then drew a distinction between reorganizations involving the purchase of the *stock* and those involving the purchase of the *assets* of the old company. It was held that where a corporation acquired from stockholders the *stock* of another corporation, giving in exchange therefor its own stock, the transaction was one by which the corporation acquiring the stock became the sole stockholder of the other corporation and that no income accrued to the corporation whose stock was thus acquired. This was true even though later the holding corporation caused the assets of the underlying company to be transferred to it for mere nominal consideration. (Reg. 33 Rev., Art. 124.) It was held that if a corporation

and any gain or profit realized thereby is taxed to the distributee as other gains or profits.[21]

EXCHANGE OF STOCK FOR OTHER STOCK OF NO GREATER PAR VALUE. In general where two (or more) corporations unite their properties by either (a), the dissolution of corporation B and the sale of its assets to corporation A; or (b) the sale of its property by B to A and the dissolution of B; or (c) the sale of the stock of B to A and the dissolution of B; or (d) the merger of B into A; or (e) the consolidation of the corporations, no taxable income is received from the transaction by A or B or the stockholders of either, provided the sole consideration received by B and its stockholders in (a), (b), (c), and (d), is stock or securities of A, and by A and B and their stockholders in (e) is stock or securities of the consolidated corporation, in any case of no greater aggregate par or face value than the old stock and securities surrendered. The term "reorganization" as used in the Revenue Act of 1918[22] includes cases of corporate readjustment where stockholders exchange their stock for the stock of a holding corporation, provided the holding corporation and the original corporation, in which it holds stock, are so closely related that the two corporations are affiliated[23] and are thus required to file consolidated returns. So-called "no-par-value" stock issued under a statute or statutes which require the corporation to fix in a certificate or on its books of account or otherwise an amount of capital or an amount of stock

sold its *assets* in whole or in part and the purchase price was paid with stock issued by the purchasing company, the purchase price would be the actual value at the time of the stock issued in payment for such assets. (Reg. 33 Rev., Art. 101; letter from Treasury Department dated September 9, 1916; I. T. S. 1918, ¶ 1297.) If the shares of stock received by the selling corporation were distributed to its stockholders, the fair market value of the stock so distributed in excess of the cost (or fair market value as of March 1, 1913) of the stock held by them in the selling corporation would be considered income to the stockholders. (Letter from Treasury Department dated September 9, 1916; I. T. S. 1918, ¶ 1297; Reg. 33 Rev., Art. 101.) If the excess over value as of March 1, 1913, or over cost, as the case might be, included any surplus earned since March 1, 1913, by the selling company, upon which the income tax had been paid, the excess or profits resulting from the sale might be reduced by the amount of such tax-paid surplus.

21 Revenue Act of 1918, § 201 (c).

22 Revenue Act of 1918, § 202.

23 See Revenue Act of 1918, § 240 (b), Reg. 45, Art. 633.

issued which may not be impaired by the distribution of dividends, will for the purpose of the rule above stated, be assumed to have a par value representing an aliquot part of such amount, the proper account being taken of any preferred stock issued with a preference as to principal. In the case (if any) in which no such amount of capital or issued stock is so required, no-par-value stock received in exchange will be regarded for purposes of the above rule as having in effect no par or face value and consequently as having "no greater aggregate par or face value" than the stock or securities exchanged therefor.[24] The phrase "In any case of no greater aggregate par or face value than the old stock and securities surrendered" is a limitation governing each of the subdivisions (a), (b), (c), (d) and (e) above.[25]

Determination of Gain or Loss from Subsequent Sale. The new stock and securities received as described in the preceding paragraph take the place of the old stock and securities. For the purpose, therefore, of ascertaining the gain derived or loss sustained from the subsequent sale of any stock of A or of the consolidated corporation so received, the original cost to the taxpayer or the fair market value as of March 1, 1913, of the stock of B or A in respect of which the new stock was issued, less any untaxed distribution made to the taxpayer by A out of the former capital or surplus of B, or by the consolidated corporation out of the former capital or surplus of A or B, is the basis for determining the amount of such gain or loss. Similarly, the cost after reorganization, merger or consolidation of the assets of A or of the consolidated corporation is the sum of the cost (or the fair market value as of March 1, 1913) of the assets of A and of B for the purpose of ascertaining the gain or loss upon a subsequent sale.[26]

Exchange of Stock for Other Stock of Greater Par Value. If in the case of any reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock and securities exchanged, income will be realized from the

24 Reg. 45, Art. 1567, as amended by T. D. 2924.

25 Letter from Treasury Department dated October 16, 1919; I. T. S. 1919, ¶ 3628.

26 Reg. 45, Art. 1568.

transaction by the recipients of the new stock or securities to an amount limited by (a) the excess of the par or face value of the new stock or securities over the par or face value of the old and (b) the excess of the fair market value of the new stock or securities over the cost or fair market value as of March 1, 1913, of the old. In other words, the taxable profit will be (a) or (b), whichever is less.[27]

DETERMINATION OF GAIN OR LOSS FROM SUBSEQUENT SALE. Upon a subsequent sale of the new stock or securities their cost to the taxpayer will be the cost or fair market value as of March 1, 1913, of the old stock and securities, plus the profit taxed on the exchange.[28]

Exchange of Property for Stock. Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction and the former owner of the property realizes a gain or loss if the stock has a market value and such market value is greater or less than the cost or the fair market value as of March 1, 1913 (if acquired prior thereto), of the property given in exchange.[29] The words "market value,"

27 Reg. 45, Art. 1569. This ruling, in so far as it taxes "the excess of the par or face value of the new stock or securities over the par or face value of the old" seems entirely unauthorized by the statute. It seems clearly to have been the intent of Congress to impose a tax only if the new stock or securities have a *market* value (in the sense indicated in note 30) and then the excess of such market value over the cost or fair market value as of March 1, 1913, of the old stock or securities exchanged. For a full discussion of the taxation of paper or artificial income founded on par values, and the limitations upon the term "equivalent of cash" see note 30.

28 Reg. 45, Art. 1569.

29 Reg. 45, Art. 1566, as amended by T. D. 2924. The Conference Committee struck out a provision of the Senate report on the Revenue Act of 1918 to the effect that when a person or persons owning property received in exchange for such property stock of a corporation formed to take over such property, no gain or loss was to be deemed to accrue from the exchange and the new stock or securities received were to be treated as taking the place of the stock, securities, or properties exchanged. The Treasury Department first ruled that where property was transferred to a corporation in exchange for its stock, if the previous owner of the property received 50% or more of the stock of the corporation, so that an interest of 50% or more in such property remained in him, then no gain or loss was realized by such owner from the transaction. For the purpose of ascertaining the gain or loss from the subsequent sale by the stockholder of any stock so received for such property, the stock was to be considered as substituted for the property, and the cost of the property

as used above, are equivalent to "fair market value" and stock is to be regarded as ordinarily having a market value even though no actual market for it can be established. Market value in this sense may therefore be regarded as the price which might reasonably be presumed would be agreed upon between a willing buyer and a willing seller.[30]

or (if acquired prior thereto) its fair market value as of March 1, 1913, was the basis for determining the amount of such gain or loss. For the purpose of ascertaining gain or loss from the subsequent sale by the corporation of any such property, the cost of the property to the former owner or (if acquired prior thereto by him) its fair market value as of March 1, 1913, was the basis for determining the amount of such gain or loss. If, however, the exchange of property and stock involved less than 50% of the stock of the corporation, such exchange constituted a closed transaction, and the former owner of the property was held to have realized a gain or loss if the stock had a market value and such market value was greater or less than the cost or (if acquired prior thereto) the fair market value as of March 1, 1913, of the property given in exchange. Where a corporation dissolved and distributed its assets in kind and not in cash, no taxable income was held to be received from the transaction by its stockholders, because they merely exchanged an indirect interest for a direct interest in the same property. (Reg. 45, Art. 1566, before the promulgation of T. D. 2924.) This ruling was later considered by the Treasury Department not to be warranted in law, and was modified to conform with the text above. (See T. D. 2924.)

30 This ruling is an attempt to tax the exchange of property for stock on the basis of the "fair cash" or "intrinsic" value of the stock received. This is to extend the provisions of the taxing statute by implication beyond the clear import of the language used, and to enlarge its operations to matters not specifically pointed out, a procedure contrary to settled rules of construction. (See cases cited in Chapter 47. The words "if any" contained in subdivision (b) of section 202 of the statute indicate that stock received in exchange for property is to be taken as the equivalent of cash *only* if such stock has a *market* value. The term "market value" means the actual price at which the commodity spoken of is commonly sold. The term is not synonymous with intrinsic value. (Douglas v. Merceles, 25 N. J. Eq. 144.) To tax exchanges of property for stock upon the basis of "fair cash" or "intrinsic" or any other kind of value not contemplated by the word "*market*" is to permit part of the statute—the words "if any" to perish by construction. It is a well-established rule of statutory construction that effect should be given to the entire statute and that one part should not be allowed to defeat another part, if by any reasonable construction the two can stand together. (U. S. v. Ninety-nine Diamonds, 139 Fed. 961; State ex rel. Arpin v. Eberhardt, 158 Wis. 20.) If property is transferred to a going established corporation having an active market for its stock and a small fraction of that stock is taken in payment thereof, the consideration undoubtedly should be treated as the

Sale of Insurance Policy. In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such policy.[31]

Sale of Patents and Copyrights. A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and the value as of March 1, 1913, if acquired prior to that date, or between the selling price and the cost, if acquired subsequently to that date. The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of depreciation of such patents or

"equivalent of cash." It is convertible into money. (See Tennant v. Smith, [1893] A. C. 150.) On the other hand, where an individual transfers assets to a newly formed corporation in exchange for all of its stock, it is equally apparent that no profit can have accrued to him from the change in the *form* of his assets. The change has been a change *in form only*. He has pieces of paper representing exactly the same property he had before the exchange. These pieces of paper stand in the place of the property. He is no richer by virtue of the transaction. In one sense he is the corporation, in spite of the legal fiction of separate corporate entity. It seems doubtful if the courts will allow any tax to be imposed upon an individual in such a case. While the precise point has never been decided, frequent decisions of the United States courts, including the Supreme Court, disregard paper transactions for income tax purposes, and even disregard the doctrine of corporate entity for many purposes. (Southern Pacific Co. v. Lowe, 247 U. S. 330, discussed at length in Chapter 19; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71, discussed at length in Chapter 19; U. S. v. Smith, 27 Fed. Cas. No. 16,341; U. S. v. Schillinger, 27 Fed. Cas. No. 16,228.) In a dictum in U. S. v. Alpha Portland Cement Co., 257 Fed. 432, 242 Fed. 978, Judge Dickinson, speaking of an income tax alleged to be due by reason of the receipt of certain stock upon a reorganization, said: "If the law is construed with these grounds, indicating its policy, in mind, we must construe the words 'income received' as meaning actually received, and not to include something which exists merely as a figment of the imagination." The above cases are all in line with the modern tendency of the courts to disregard paper or bookkeeping transactions for purposes of income tax liability. (See Doyle v. Mitchell, 247 U. S. 179; Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704; U. S. v. Guggenheim Exploration Co., 238 Fed. 231); and also the modern tendency of the courts to look beyond the corporate form to the purpose of it, and to ignore corporate entity in favor of the substance of things. (See McCaskill v. U. S., 216 U. S. 504; U. S. v. Lehigh Valley Co., 220 U. S. 254; U. S. v. Milwaukee Co., 142 Fed. 247, 253; In re Watertown Paper Co., 169 Fed. 252.)

31 Reg. 45, Art. 87.

copyrights since February 28, 1913, or since the date of acquisition if subsequently thereto.[32]

Sale of Good Will. Any profit or loss resulting from an investment in good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be determined upon the basis of the cost of the assets, including good will, or their fair market value as of March 1, 1913, if acquired prior thereto. If nothing was paid for good will acquired after February 28, 1913, no deductible loss is possible, although, on the other hand, upon the sale of the business there may be a profit. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good will sold.[33]

Sale of Personal Property on Installment Plan. Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25 per cent) that the sale, though involving deferred payments, is not one on the installment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash, but a different rule applies to sales on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present-transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all these plans, it is desirable that a uniformly applicable rule be established.

[32] Reg. 45, Art. 40.
[33] Reg. 45, Art. 41.

The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking that proportion of the total payments received in the taxable year from installment sales (always including payments received in the taxable year on account of sales effected in earlier years as well as those effected in the taxable year) which the gross profit to be realized on the total installment sales made during the taxable year bears to the gross contract price of all such sales made during the taxable year. If, for any reason, the vendee defaults in his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any.[34] If

[34] Reg. 45, Art. 42. In England it has been held that the phrase, "annuities or other annual profits or gains," as used in 5 & 6 Vict., Chapter 35, § 102, which imposes an income tax on same, does not apply to instalments of the purchase price of an estate, although such payments are due yearly and extend over a long period of years, the instalments being regarded as parts of a debt or capital, and not profits and gains to which the act applies, and this even though a part of the instalments consists of profits. (Foley v. Fletcher [1858] 3 Hurst. & N. 769, 157 Eng. Reprint, 678, 28 L. J. Exch. N. S. 100, 5 Jur. N. S. 342, 7 Week. Rep. 141, 4 Mor. Min. Rep. 130.) In regard to sales, both of real and personal property, where title passes immediately to the vendee, the Treasury Department's early rulings permitted the return of the profits from the sale as income for the year in which the sale was made. If the buyer forfeited his contract and failed to meet any of the payments contracted to be made, the vendor was permitted to deduct from his gross income as a loss such proportion of the defaulted payments as was previously returned as income. The early rulings, where title did not pass absolutely to the vendee, are contained in a letter from the Treasury Department dated March 14, 1917; Income Tax Primer, December 17, 1917, Question 32. On April 25, 1918, in T. D. 2707 the Treasury Department modified Reg. 33 Rev., Arts. 117 and 120 and established the ruling that until personal property sold on the instalment plan is fully paid for, the income to be returned by the vendor will be that proportion of each instalment pay-

the vendee defaults in installment payments and the vendor is unable to recover the personal property sold, he should report as loss on the return for that year the difference between the total amount actually received and the cost plus amounts returned as profits from sales during former years.[35] Income from installment sales to be returned in each taxable year will consist of: (1) Such part of the installments received during the year (excluding those installments received on account of property repossessed during the year) as represents realized profit. Installments received during the year are to be included whether the sales were effected in an earlier or in the current taxable year. The profit on such installments should be computed by taking the same percentage of the installment receipts as the gross profit to be realized on the total installment sales made during the taxable year bears to the gross contract price of all such sales. Any necessary corrections to produce a more accurate result can be made as at the end of the taxable year. (2) The profit, if any, on contracts which during the year have been cancelled, the goods being repossessed by the vendor. In such cases the entire profit realized on the cancelled contract, less so much thereof as has been returned in previous years, should be returned as profit of the taxable year in which the goods are repossessed. In estimating such profit the value of the repossessed article (taken at its cost to vendor, less proper allowance for damage and use) should be taken into account, as well as all installments received on account of the contract. Where an installment house makes sales which are not on the installment plan, the profit on such completed sales will be determined in the regular manner.[36] The following is an illustration of the computation of income from sales of personal property on the installment plan: In 1917 goods which cost $10,000 are sold on installment plan for $20,000. Collections on account: 1917, $10,-000; 1918, $9,800. One contract, originally for $500, is defaulted in 1918 and the goods which cost the vendor $250 are repossessed,

ment which the gross profit to be realized when the property is paid for bears to the gross contract price.

35 Letter from Treasury Department dated July 10, 1919; I. T. S. 1919, ¶ 3486.

36 Letter from Treasury Department dated April 26, 1919; I. T. S. 1919 ¶ 3317.

being then worth $50. Installments on this defaulted contract had been paid as follows: 1917, $100; in 1918, $200. The profits to be returned in 1918 are:

Under (1) 50% of $9,600 ($9,800—$200)			$4,800
Under (2) total installments received		$300	
Less-Profit returned in 1917	$ 50		
Shrinkage in goods repossessed ($250—$50)	200		
		250	
			50
Total profit returnable in 1918			$4,850

For simplicity, the above illustration omits sales in 1918. If sales in 1918 contain a different percentage of profit than those in 1917, some adjustment may be necessary. Where the adoption of the method outlined above involves a change in the method of computing net income, the taxpayer's balance sheet should be adjusted conformably as of the date when the change is effected. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.[37] In case the taxpayer has heretofore made return upon the basis of treating all installment sales as the equivalent of cash, he should adopt the following procedure: In accordance with the rule above stated, the first step to be taken by the taxpayer is to prepare and file as part of his return an amended balance sheet as at the date of the beginning of the taxable year, in which there shall be excluded from the surplus the unrealized gross profits upon the outstanding installment sales contracts at that date. Such amended balance sheet would be in substantially the following form:

Balance Sheet as at Opening of Fiscal Year.

Assets		Liabilities	
Plant and equipment	$....	Capital stock (or individual's or partner's capital)	$....
Less depreciation	$....		
	$....	Mortgage indebtedness	$....
			$....

[37] Letter from Treasury Department dated July 10, 1919; I. T. S. 1919, ¶ 3486.

Current assets:		Current liabilities:	
Merchandise as per inv.	$....	Bills payable	$....
Instal. sales contrs.	$....	Accounts payable	$....
Notes receivable	$....	Wages or other accrued items	$....
Accounts receivable	$....		$....
Cash	$....		
	$....		
Deferred Debit Items:		Deferred Credit Items:	
Insurance premium paid in advance	$....	Unrealized gross profits upon instal. sales contrs.	$....
Other items:		Surplus	$....
Total assets	$...	Total liabilities	$....

As from the beginning of the taxable year the following accounts should be set up: (a) *Goods purchased* which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year; (b) *Goods sold (cost value),* which will be credited with the cost value of all goods sold during the year; (c) *Installment Sales Contracts* which will be charged with the amount of the outstanding installment sales contracts at the beginning of the year and with the amount of installment sales contracts made during the year. This account will be credited with all cash collected during the year upon installment sales contracts and with the unpaid installments of defaulted or cancelled contracts. (d) *Unrealized Gross Profits on installment sales contracts* which will be credited with the amount of unrealized gross profits upon the outstanding installment sales contracts at the beginning of the year, and with the amount of such unrealized gross profit upon installment sales contracts made during the year. This amount will be computed upon the basis of the total installment sales contracts reduced by the cost or inventory value of the goods covered by the contracts, the remaining balance being the amount of the unrealized gross profits. (e) *Realized Profits on installment sales contracts* which will be credited from month to month, or at least at the end of the year, with the profits realized by collection upon installment sales contracts.

Such profits should be computed by taking the same percentage of the total cash collections upon installment sales contracts during the period as the total unrealized profits on installment sales contracts bears to the total installment sales during the same year. Corresponding debits should be made to unrealized gross profits on installment sales contracts. Any necessary corrections to produce a more accurate result can be made as at the end of the fiscal year. It will be noted that the foregoing plan, which will be permitted upon an explicit statement of facts made to the Commissioner by a taxpayer engaged in merchandising upon the installment plan, is not a change from an accrual basis to a cash received and paid basis. It is the opinion of the Treasury Department that the income of a merchandising concern cannot be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is therefore merely a modification or adaptation of the ordinary accrual method of accounting which will enable the accounts of the taxpayer to clearly reflect his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income, an amended return or returns for such year may be made.[38]

Sale of Real Estate in Lots. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the entire fair market value as of March 1, 1913, or the cost, if acquired subsequently to that date, must be equitably apportioned to the several lots or parcels and made a matter of record in the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss in every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for accordingly.[39]

[38] Letter from Treasury Department dated July 9, 1919; I. T. S. 1919, ¶ 3476.

[39] Reg. 45, Art. 43; Reg. 33 Rev., Art. 117.

Sale of Real Estate Involving Deferred Payments. Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows: (1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (a) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (b) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid. (2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments. In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future.[40]

Sale of Real Estate on Installment Plan. In the two kinds of transactions included in class (1) in the foregoing paragraph, installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor, and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory less any depreciation.

[40] Reg. 45, Art. 44.

Such profits should be computed by taking the same percentage of the total cash collections upon installment sales contracts during the period as the total unrealized profits on installment sales contracts bears to the total installment sales during the same year. Corresponding debits should be made to unrealized gross profits on installment sales contracts. Any necessary corrections to produce a more accurate result can be made as at the end of the fiscal year. It will be noted that the foregoing plan, which will be permitted upon an explicit statement of facts made to the Commissioner by a taxpayer engaged in merchandising upon the installment plan, is not a change from an accrual basis to a cash received and paid basis. It is the opinion of the Treasury Department that the income of a merchandising concern cannot be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is therefore merely a modification or adaptation of the ordinary accrual method of accounting which will enable the accounts of the taxpayer to clearly reflect his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income, an amended return or returns for such year may be made.[38]

Sale of Real Estate in Lots. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the entire fair market value as of March 1, 1913, or the cost, if acquired subsequently to that date, must be equitably apportioned to the several lots or parcels and made a matter of record in the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss in every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for accordingly.[39]

38 Letter from Treasury Department dated July 9, 1919; I. T. S. 1919, ¶ 3476.

39 Reg. 45, Art. 43; Reg. 33 Rev., Art. 117.

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SALE OF REAL ESTATE ON INSTALLMENT PLAN. In the two kinds of transactions included in class (1) in the foregoing paragraph, installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor, and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory less any depreciation.

[40] Reg. 45, Art. 44.

If the taxpayer chooses, as a matter of settled practice consistently followed, to treat the obligations of the purchaser as equivalent to cash and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in the following paragraph will apply.[41]

DEFERRED PAYMENT SALES OF REAL ESTATE NOT ON THE INSTALLMENT PLAN. In class (2) in the next to the last paragraph above the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. These obligations for deferred payments are therefore to be regarded as equivalent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed. If the buyer defaults and the seller regains title to the land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss in the year of repossession any excess of the amount previously reported as income over the amount actually received, and must include such real estate in his inventory at its original cost to himself less any depreciation.[42]

41 Reg. 45, Art. 45.
42 Reg. 45, Art. 46.

CHAPTER 18

INCOME FROM INTEREST, RENT AND ROYALTIES

The Revenue Act of 1918 expressly provides that gross income shall include gains, profits, and income derived from "interest" and from "rent." It does not expressly cover income from royalties, which falls, however, under the broad expression "income derived from sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also gains or profits and income derived from any source whatever." Interest is ordinarily taxable in the hands of citizens and residents and domestic corporations, whether received from debtors in this country or debtors in foreign countries. It is taxable in the hands of non-resident aliens and foreign corporations when it is paid on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.[1]

Interest Exempt from Tax. The Revenue Act of 1918 expressly provides that interest upon the obligations of a State, territory or political subdivision thereof, or the District of Columbia or any possession of the United States, or securities issued under provisions of the Federal Farm Loan Act of July 17, 1916, or interest upon the obligations of the United States issued prior to September 1, 1917, (and to a limited extent the interest on obligations issued after that date) and bonds issued by the War Finance Corporation (to a limited extent) shall not be included in gross income, and shall be exempt from income tax.[2]

Interest upon United States Obligations. Although interest upon the obligations of the United States is in general exempt

1 Revenue Act of 1918, § 213 (a), 233. See Chapter 4. As to interest, see Reg. 33, Art. 67; Letter from Treasury Department dated February 18, 1915; I. T. S. 1919; ¶ 923, Reg. 45, Art. 54. As to rent, see Letters from Treasury Department dated February 9 and February 26, 1915. I. T. S. 1919, ¶ 920. Unless the taxpayer keeps his books on a basis other than that of actual receipts, he should report interest, rent and royalties as income of the year in which payment thereof is actually or constructively received by him.

2 Revenue Act of 1918, § 213 (b) 4.

from tax, in the case of such obligations issued after September 1, 1917, which include Treasury certificates of indebtedness, war savings certificates and the liberty bond issues (except the First Liberty Loan 3½ per cent. bonds), the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.[3] There are five issues of so-called Liberty Loan bonds comprising ten different classes of bonds and notes. These ten classes are as follows: (1) First Liberty Loan 3½% Bonds; (2) First Liberty Loan Converted 4% Bonds; (3) First Liberty Loan Converted 4¼% Bonds (dated May 9, 1918); (4) First Liberty Loan 4¼% Bonds (dated October 24, 1918); (5) Second Liberty Loan 4% Bonds; (6) Second Liberty Loan Converted 4¼% Bonds; (7) Third Liberty Loan 4¼% Bonds; (8) Fourth Liberty Loan 4¼% Bonds; (9) Victory (Fifth) Liberty Loan 3¾% Notes; (10) Victory (Fifth) Liberty Loan 4¾% Notes. The respective acts[4] authorizing the issue of these obligations grant exemption in every case from any *normal*[5] tax upon the interest therefrom. Some of the obligations are wholly exempt from the surtax or the excess-profits tax (in the case of corporations), while others carry no exemption from such taxes. In addition, many of the obligations carry limited or partial exemptions as appears in the following paragraph.

TAX EXEMPTIONS OF LIBERTY BONDS AND VICTORY NOTES. I. The following bonds and notes are exempt from all Federal, State, and local taxation, except (a) estate or inheritance taxes and (b) Federal income surtaxes and profits taxes, as follows:

[3] Reg. 45, Art. 77. Under earlier income tax laws, interest upon the obligations of the United States was expressly included as taxable income (see Act of March 2, 1867). Under the 1909 Law the Attorney General held that interest on national bonds should be included as income of corporations, since the tax was not on property, but a tax on the privilege of carrying on business (28 Op. Atty. Gen. 138).

[4] Act of April 24, 1917; Act of September 24, 1917; Act of April 4, 1918; Act of July 9, 1918; Act of March 3, 1919.

[5] This word applies to the income tax on corporations as well as the normal tax on individuals. (Official announcement by Treasury Department. dated April 23, 1919; I. T. S. 1919, ¶ 3311.)

1. First Liberty loan converted 4 per cent bonds of 1932-1947 (first 4s).
2. First Liberty loan converted 4¼ per cent bonds of 1932-1947 (first 4¼s, issue of May 9, 1918).
3. First Liberty loan second converted 4¼ per cent. bonds of 1932-1947 (first 4¼s, issue of October 24, 1918).
4. Second Liberty loan 4 per cent bonds of 1927-1942 (second 4s).
5. Second Liberty loan converted 4¼ per cent bonds of 1927-1942 (second 4¼s).
6. Third Liberty loan 4¼ per cent bonds of 1928 (third 4¼s).
7. Fourth Liberty loan 4¼ per cent bonds of 1933-1938 (fourth 4¼s).
8. Victory Liberty loan 4¾ per cent convertible gold notes of 1922-1923 (4¾ per cent Victory notes).

Are exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States or by any local taxing authority except (*a*) estate or inheritance taxes, and (*b*) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations.

II. 4 *per cent and* 4¼ *per cent bonds* are entitled to limited exemptions from Federal income surtaxes and excess-profits taxes, as follows:

4 per cent and 4¼ per cent Liberty bonds (but not 4¾ per cent Victory notes) are entitled to certain limited exemptions from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations, in respect to the interest on principal amounts thereof, as follows:

$5,000 in the aggregate of first 4s, first 4¼s (issues of May 9 and October 24, 1918) second 4s and 4¼s, third 4¼s, fourth 4¼s, Treasury certificates, and war-saving certificates.[6]

30,000 of first 4¼s (issue of October 24, 1918, only), until the expiration of two years after the termination of the war.

30,000 of fourth 4¼s, until the expiration of two years after the termination of the war.

30,000 in the aggregate of first 4s, first 4¼s (issues of May 9 and October 24, 1918), second 4s and 4¼s, third 4¼s, and fourth 4¼s, as to the interest received on and after January 1, 1919, until the expiration of five years after the termination of the war.

45,000 in the aggregate of first 4s, first 4¼s (issue of May 9, 1918, only), second 4s and 4¼s, and third 4¼s, as to the interest received after January 1, 1918, until the expiration of two years after the termination of the war; this exemption conditional on original subscription to, and continued holding at the date of the tax return of two-thirds as many bonds of the fourth Liberty loan.[7]

20,000 in the aggregate of first 4s, first 4¼s (issues of May 9, and October 24, 1918), second 4s and 4¼s, third 4¼s, and fourth 4¼s, as to the interest received on and after January 1, 1919; this exemption conditional upon original

[6] Where a husband and wife each own in his own or her own right bonds of these issues not exceeding $5,000, each is entitled to exclude the income therefrom in computing the tax on their joint incomes, and minor children having separate estates are also entitled to the exemption. (Letter from Treasury Department dated October 8, 1917, I. T. S. 1918, ¶ 447.) A taxpayer is entitled to the exemption of $5,000 of his aggregate holdings, not on $5,000 of each class of obligations (T. D. 2585).

[7] It has been held that an individual who originally subscribed to bonds of the Fourth Liberty Loan to an amount not exceeding $30,000 in accordance with the Government plan and, who made payments in accordance with such plan is not required to pay for such bonds in full on or before December 31, 1918, in order to obtain this exemption. Likewise, if an individual subscribed for bonds of the Fourth Liberty Loan through a bank by agreeing to pay the subscription price in installments acceptable to the bank, and make payments in accordance with this plan, it will not be necessary for such individual to pay for the bonds in full on or before December 31, 1918, in order to obtain this exemption. (Letter from Treasury Department dated January 3, 1919, I. T. S. 1919, ¶ 990.)

subscription to, and continued holding at the date of the tax return of one-third as many notes of the Victory Liberty loan, and extending through the life of such notes of the Victory Liberty loan.[8]

III. 3½ *per cent bonds and* 3¾ *per cent notes* are exempt from all Federal, State, and local taxation, except estate or inheritance taxes, as follows:

1. First Liberty loan 3½ per cent bonds of 1932-1947. 2. Victory Liberty loan 3¾ per cent convertible gold notes of 1922-1923.[9]	Are exempt, both as to principal and interest, from all taxation (except estate or inheritance taxes) now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority.

EXEMPTION DETERMINED BY BONDS HELD AT END OF YEAR. Where a taxpayer converts bonds in the course of a year, he is deemed, for purposes of the income tax, to have held for the entire year the bonds into which his earlier bonds are converted. All amounts paid at the time of conversion of bonds for adjustment of interest are to be subtracted from amounts received at the first interest payment after conversion and only the difference between amounts received and amounts paid is to be included in the return of taxpayer.[10] All interest accrued on 4¾ per cent Victory notes at the date of any conversion by the taxpayer into 3¾ per cent Victory notes will, for the purposes of computing net income, be deemed to be interest upon 4¾ per cent Victory notes, and will be entitled only to the exemptions from taxation to which interest on 4¾ per cent Victory notes is entitled. Any

[8] For the purpose of this exemption Victory notes of either series issued upon conversion of Victory notes of the other series which were originally subscribed for by any taxpayer will be deemed to have been originally subscribed for by such taxpayer. (T. D. 2857.) The total possible exemptions from Federal income surtaxes and profits taxes, subject to conditions above summarized, is $160,000.

[9] T. D. 2836; Official Statement by the Secretary of the Treasury, dated April 14, 1919; I. T. S. 1919, ¶ 3297; Reg. 45, Arts. 78-80; Letter from Treasury Department dated March 20, 1919; I. T. S. 1919, ¶ 3278.

[10] Letter from Treasury Department dated March 25, 1919; I. T. S. 1919, ¶ 3284.

and all amounts received by any taxpayer from the United States by way of adjustment of accrued interest upon conversion of 4¾ per cent Victory notes into 3¾ per cent Victory notes will be deemed to be interest upon 4¾ per cent Victory notes. All interest accrued on 3¾ per cent Victory notes at the date of any conversion by the taxpayer into 4¾ per cent Victory notes will, for the purposes of computing net income, be deemed to be interest upon 3¾ per cent Victory notes, and will be entitled to the exemptions from taxation to which interest on 3¾ per cent Victory notes is entitled.[11]

WAR FINANCE CORPORATION BONDS. The War Finance Corporation Act makes the same provision for the exemption of interest upon bonds issued by the War Finance Corporation as is provided in the case of Second Liberty Loan Bonds; that is, interest on an amount of such bonds, the principal of which does not exceed in the aggregate $5,000 owned by any individual, partnership, corporation or association is exempt.[12]

POSTAL SAVINGS ACCOUNTS. Interest credited to postal savings accounts upon moneys deposited in postal savings banks on or before September 1, 1917, is exempt from income tax, while interest credited upon deposits made subsequently to September 1, 1917, is liable to tax.[13]

FOOD ADMINISTRATION GRAIN CORPORATION NOTES. Interest on Food Administration Grain Corporation notes is not exempt from income tax.[14]

Interest from Federal Land Bank and National Farm Loan Association. As the Federal Farm Loan Act[15] provides that every Federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of Federal land banks and national farm

11 T. D. 2865.

12 Act of April 5, 1918 (Public No. 121), § 16. See note 6.

13 Reg. 45, Art. 77.

14 Telegram from Treasury Department dated April 13, 1919; I. T. S. 1919, ¶ 3296.

15 Act of July 17, 1916, § 26.

loan associations and from interest on such farm loan bonds is not subject to the income tax.[16]

Obligations of the Possessions of the United States. Interest paid on the obligations of possessions of the United States is exempt.[17]

Obligations of Territories. Interest on the obligations of the Territories, or political subdivisions thereof, is exempt.[18]

Obligations of the District of Columbia. Interest upon obligations of the District of Columbia is now exempt.[19]

Interest on the Obligations of States. The same principle which denies to a State power to raise revenue by taxation on Federal property, or sources of revenue, or means of carrying on its duties, forbids taxation of State revenue for Federal purposes.[20] Therefore the United States has no power under the Constitution to tax either the instrumentalities or the property of a State.[21] A municipal corporation is a portion of the sovereign power of a State and is not subject to taxation by Congress upon its municipal revenue.[22] But the exemption of State agencies does not extend to those used by the State in carrying on an ordinary private business.[23] Interest on the obligations of a State is, therefore, expressly exempt. The 1909 Law, however, being an excise tax and not an income tax, was valid although measured by income which included interest from State securities.[24]

POLITICAL SUBDIVISION OF A STATE. A political subdivision denotes any division of a State or Territory made by the proper authorities thereof acting within their constitutional powers for the purpose of carrying out a portion of those functions of the

16 Reg. 45, Art. 75.

17 Revenue Act of 1918, § 213 (b) 4.

18 Such interest was not exempt under the 1916 Law, since the law did not expressly include territories in the exemption provision. (Revenue Act of 1916, § 4.)

19 Such interest was not expressly included in the exemption provision of the 1916 Law. Compare Revenue Act of 1918 § 213 (b) 4 and Revenue Act of 1916, § 4.

20 Collector v. Day, 11 Wall. 113; Dobbins v. Erie Co., 16 Pet. 435; Ambrosini v. U. S., 187 U. S. 1.

21 Pollock v. Farmers' Loan and Trust Company, 157 U. S. 429, 584.

22 U. S. v. B. & O. Railroad Company, 17 Wall. 322.

23 South Carolina v. U. S., 199 U. S. 437.

24 Flint v. Stone Tracy Co., 220 U. S. 107.

State or Territory which by long usage and the inherent necessities of government have always been regarded as public.[25] The Attorney General has held that special assessment districts created for a public purpose, such as the improvement of streets and public highways, the provision of sewage, gas and light and the reclamation, drainage, or irrigation of land are districts for public use, and consequently political subdivisions of the State, within the meaning of the law.[26] Political subdivisions of a State or Territory, within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.[27] However, a district without power to exercise any governmental function, created for the purpose of making some improvement, primarily beneficial to the property located in and comprising the district, is not, within the meaning of these acts, a political subdivision of the State. Obligations issued in payment for such improvement, although guaranteed by a county, municipality, or other political subdivision of the State, are not the obligations of the State or of any political subdivision thereof; but are rather the obligations of the benefited property upon which they constitute a lien. Hence, the income derived from obligations which are a direct charge against or lien upon benefited

25 A political subdivision, according to the court in the case of Smith v. Howell, 60 N. J. L. 384, is "A division of the state, with its inhabitants organized for the public advantage and not in the interest of particular individuals or classes, the chief design of which is the exercise of governmental functions, and to the electors residing within which is, to some extent, committed the power of local government."

26 Opinion of Attorney General dated January 30, 1914. In the course of his opinion the Attorney General said: "* * * where the power to levy a tax is given a district by the state, presumptively that district is created for a public use, and is exercising a public function. * * * Nor does it make any difference that the tax is measured by the benefit conferred." But he refrained from expressing any opinion whether assessment districts might not be created for a purely private purpose so as to bring them within the principles laid down in the South Carolina Dispensary case, 199 U. S. 437, rather than within those which governed U. S. v. B. & O. Railroad Company, 17 Wall. 322.

27 Reg. 45, Art. 74; T. D. 1946.

property is not exempt and must be returned as income of the recipient.[28]

MORTGAGE ASSUMED BY STATE OR MUNICIPALITY. Although interest on State or municipal bonds is exempt from the tax, yet where a State or municipality has purchased a public utility subject to a mortgage, and the mortgage retains its original character, even though the State or municipality assumes the mortgage indebtedness and pays the interest thereon, the mortgage does not become an obligation of the State or municipality within the meaning of the law and the interest thereon is not exempt.[29]

Interest on Bonds of Exempt Organizations. Although a corporation may be exempt[30] from tax on its income, yet interest on the bonds of such an organization is taxable income to the bondholder.[31]

Reporting Exempt Income. Income from United States obligations issued prior to September 1, 1917, interest on bonds of States, territories (and political subdivisions thereof) possessions of the United States and the District of Columbia, need not be included in gross income, but the amount of such securities owned by the taxpayer and the income therefrom must be stated in his return.[32]

28 Reg. 33 Rev., Art. 84.

29 Reg. 45, Art. 74; T. D. 2090.

30 Revenue Act of 1918, § 230.

31 Letter from Treasury Department dated July 30, 1914; I. T. S. 1918, ¶ 1319.

32 Revenue Act of 1918, § 213 (b) 4. It has been asserted that this provision is unconstitutional in that it imposes a burden upon State and municipal obligations of compeling the owner to make a computation and disclosure of his income therefrom—a burden which, if admitted in principle could be stretched to such an extent that the owner would prefer to pay the tax in order to escape the greater burden of supplying the Government with a mass of detail in regard to his ownership of such obligations. Congress seems to have no general power to make inquiry into the affairs of a citizen or to investigate the affairs of citizens as a mere matter of private concern or Governmental curiosity (Interstate Commerce Commission v. Brimson, 154 U. S. 447; In re Chapman, 166 U. S. 661, 668; Kilbourn v. Thompson, 103 U. S. 168; Harriman v. Interstate Commerce Commission, 211 U. S. 407; In re Pacific Ry. Commission, 32 Fed. 241) and an individual may refuse to answer an unauthorized inquiry. (Boyd v. U. S. 116 U. S. 616.) Regarding the question from the standpoint of individual liberty and privacy or from the standpoint of authority in a particular case to make inquiry and compel

Accrued Interest on Obligations at Time of Purchase. Where a purchaser pays the price of the security purchased and an additional sum representing accrued interest, the amount of interest received on the next interest date should not be reported in full. The amount of accrued interest at the time of purchase represents the return of capital to the purchaser and he should deduct such amount from the interest received, and report the remainder only. The seller of the security should account in his return for the accrued interest received at the time of sale, since to him that amount is income.[33]

Interest on Bank Deposits. Interest on bank deposits or on certificates of deposit, credited to the account of the depositor by the bank, is income for the year in which the credit is made. This is true even though the bank nominally have a rule, seldom or never enforced, that it may require a certain number of days' notice in advance of cashing depositors' checks.[34]

Interest Received and Paid by Brokers. Where the customers of a brokerage house buy securities, paying only a part of the purchase price and paying interest on the balance, and the brokerage house buys such securities from others, paying only a part of the purchase price and paying interest on the balance, the brokerage house must include in its return as gross income the interest received from the customers and may deduct as interest the amount of interest it pays on such purchases.[35]

answer, it is difficult to see in the above inquiry as to state and municipal obligations any legitimate purpose connected with the raising of revenue or any other function of the Federal Government. It does not seem that taxpayers should be obliged to speculate as to a possible undisclosed purpose on the part of Congress which might render the provision authorized and proper. (See 53 N. H. 635.)

[33] Reg. 33 Rev., Art. 4; Letter from Treasury Department dated February 5, 1915; I. T. S. 1918, ¶ 360. In a later ruling the Treasury Department declined to permit the taxpayer in such a case to report all of the interest received as income and to deduct the amount of accrued interest paid at the time of purchase as an expense or as interest paid by the purchaser. (Letter dated March 8, 1915, I. T. S. 1917, ¶ 237.)

[34] Reg. 33, Art. 67; Letter from Treasury Department dated February 18, 1915; I. T. S. 1919, ¶ 855. Reg. 45, Art. 54.

[35] Altheimer Rawlings Investment Co. v. Allen, 248 Fed. 688, petition for writ of certiorari to United States Supreme Court denied November 11, 1918; see T. D. 2686 and T. D. 2441. This case was decided under the 1909 Law, but the principle seems to apply under the language of the present law. In-

Interest Accruing Prior to March 1, 1913. Interest due prior to March 1, 1913, could have been reduced to possession on demand prior to the incidence of the income tax. It is, therefore, capital. Interest accruing on or after that date is taxable income. Where an interest-bearing claim contracted prior to March 1, 1913, is paid in whole or in part after that date, any gain derived from the conversion of the claim into money is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest), exclusive of any interest accrued since February 28, 1913, already returned as income, over the fair market value of the claim as of March 1, 1913 (both principal and interest then accrued).[36]

Rent. Rent, like all other income, may be received in cash, in kind, or in the equivalent of cash. The questions arising under the income tax law with regard to rent usually relate to the taxable period for which rent income is to be reported, or to situations involving the payment of rent in some form other than cash. The following paragraphs deal with the latter kind of question.

VALUE OF IMPROVEMENTS MADE BY TENANT. Where, under the terms of a lease a tenant agrees to erect a building or to expend during the period of the lease a certain fixed sum in making improvements upon the freehold of the lessor, the building or permanent improvement becomes a part of the realty unless otherwise agreed upon between the contracting parties. When improvements made by a lessee become part of the real estate, the value of such improvements upon the expiration of the existing term of the lease is held by the Treasury Department to be income to the lessor. The amount of the gain or profit to the lessor at the expiration of the lease is the difference betwen the cost of the building or improvement so made by the tenant and a rea-

terest would be deducted in full if paid on collateral the subject of sale in the ordinary course of business. The amount of such interest deductible in the case of corporations was limited under the 1916 Law. See Appendix.

36 Reg. 45, Art. 87. Even where interest has been in default since a time prior to March 1, 1913, and funds to pay the same have accrued since that date, it has been held that the interest represents income accrued to the owners of the bonds prior to the incidence of the tax, and hence does not constitute taxable income when received thereafter. (Letter from Collector at Cincinnati dated March 16, 1915, embodying decision of the Treasury Department; I. T. S. 1919, ¶ 1010.)

sonable allowance for depreciation during the period of its life under the lease.[37] The Courts, however, have held that where the owner of land leases the same under an agreement requiring the tenant to construct a building thereon, and also to pay an annual rental, and such owner retakes possession upon the tenants' default in payment of rent, the title to the building, having vested in the owner immediately upon construction, its value does not constitute income to the owner in the year of default and repossession.[38]

PAYMENTS BY TENANT ON BEHALF OF LANDLORD. In general, sums paid by a tenant for the use of property, although to another than the landlord, are properly to be regarded as rent and constitute income of the landlord.[39] Where under the terms of a lease a tenant pays or incurs liability for taxes, repairs or interest for and on behalf of the landlord, such payments constitute income to the landlord. The theory covering these transactions is that the tenant is acting merely as agent for the landlord in making the payments. The expenses are deductible by the landlord, and the amounts used to defray such expenses must be reported by the landlord as his income.[40] Such payments may be deducted by the tenant as rent in the year in which they are paid.[41]

RECEIPT OF RENT IN KIND. Where rent is received in the form of produce, as for instance, a share of the crops of a farm, and such produce or crops have no definite market value, the amount realized on the sale of such share must be included as income in the year in which the share is disposed of or redueed to money or its equivalent. Where board or lodging is given as the equivalent of rent, the value of such board or lodging is required to be included.

37 Reg. 45, Art. 48; Reg. 33 Rev., Art. 4; T. D. 2442. It necessarily follows that the tenant may consider the cost of the building as a part of his rental payments and may deduct such amounts as an expense, pro-rating the original cost over the number of years constituting the term of the lease.

38 Miller v. Gearin, 258 Fed. 225. The court held the sole question in this case to be, "When was the income received or derived?" The lease having been made in 1906, the building erected in 1907, and default occurring in 1916, the value of the building was held to be income received or derived in 1907.

39 Reg. 45, Art. 48.

40 Reg. 33 Rev., Art. 4.

41 Reg. 33 Rev., Art. 8.

Royalties. Amounts received as royalties are income in the taxable year of receipt, actual or constructive, or in the taxable year in which they accrue, accordingly as the taxpayer reports his income on the basis of receipts or accruals. Royalties fall under the broad expression "income derived from sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also gains or profits and income derived from any source whatever."[42]

ROYALTIES FROM MINES. It has been contended that royalties received under leases of oil, gas, and solid minerals are in fact not income but payments of installments on the purchase price of the natural deposit. The nature and effect of such leases has been the subject of some difference of opinion in the courts. It has been held that the leases are leases in name only; that they are in fact conveyances of the ore body or oil and gas in place as a part of the realty; that the so-called royalties merely represent payments for so much land and are in no just sense income, but mere conversions of the capital.[43] On the other hand, it has been held that leases of solid mineral rights do not constitute a sale of any part of the land or a sale of ore in place, and that the royalties payable constitute the rents and profits of the land.[44]

42 Revenue Act of 1918, § 213 (a). It has been held that royalties received by a corporation in accordance with a contract by which it has assigned the patent rights to manufacture machines, etc., are income and should be so accounted for (Reg. 33 Rev., Art. 113; letter from Treasury Department dated January 24, 1916; I. T. S. 1918, ¶ 1262) and that royalties paid to a proprietor by those who are allowed to develop or use property or operate under some right belonging to such proprietor are also to be accounted for as income. (Reg. 33 Rev., Art. 4.)

43 See Hook v. Garfield Coal Co., 112 Ia. 210, 83 N. W. 963; Wilson v. Youst, 43 W. Va. 826, 28 S. E. 781; Manning v. Frazier, 96 Ill. 279; Spooner v. Phillips, 62 Conn. 62, 24 Atl. 524; Wilcox v. Middlesex County, 103 Mass. 544; Plummer v. Hillsdale Coal etc. Co., 163 Pa. 483, 28 Atl. 853; Barnsdall v. Bradford Gas Co., 225 Pa. 338, 74 Atl. 207.

44 T D. 2152; Von Baumbach v. Sargent Land Co., 242 U. S. 503; U. S. v. Bibawik Mining Co., 247 U. S. 116; Stratton's Independence v. Baltic Mining Co., 240 U. S. 103; State v. Evans, 99 Minn. 220, 108 N. W. 958; Boeing v. Owsley, 122 Minn. 190, 142 N. W. 129; State v. Royal Mineral Association, 132 Minn. 232, 156 N. W. 128; Reg. v. Westbrook, 10 Q. B. 178, 205, 22 Eng. Rul. Cas. 623. The leases involved in the Sargent Case were leases of iron

ROYALTIES FROM PATENTS AND COPYRIGHTS. Royalties on patents are income.[45] Taxpayers receiving royalties from patents, copyrights, or other similar forms of property, may deduct from each payment a proportionate part of the cost thereof as representing a return of capital. This is more fully discussed in a subsequent chapter.[46]

ore lands and they contained substantially the following provisions: (1) that the owners leased to the lessees exclusively all the lands described for the purpose of exploring for, mining, and removing the ore which might be found therein for the period of fifty years; (2) the lessees were given the exclusive right to occupy and control the leased premises and to erect all necessary buildings, etc., thereon, (3) right was reserved to the lessors to enter for the purpose of ascertaining the amount of ore mined and removed and of making observations, etc.; (4) the lessees agreed to pay in most cases a certain price per ton for all ore mined and removed; (5) the lessees agreed to mine and ship a specified quantity of ore each year in default of which they agreed to pay the lessors for a minimum amount; (6) the lessees agreed to pay taxes and to keep the property free from encumbrances; (7) the lessors reserved the right to terminate the lease upon default of the lessees; (8) the lessees had the right to terminate the leases upon sixty days notice. The Supreme Court held that moneys received under these leases did not represent, in whole or in part, conversion of the investment of the lessors from ore into money, but on the contrary they represented the rents and profits of the land, to be accounted for as income by the recipient lessors. In the Biwabik Case the leases involved contained substantially similar provisions and the lands leased contained deposits of iron ore. The Court expressly stated in this case that its findings in the Sargent Case left "little room to suppose that this Court made its decision concerning the rights of the lessor influenced by the fact that the land itself was the chief thing, and the ownership of it after the exhaustion of the minerals one of the controlling reasons in reaching the conclusion announced in that case." The Court repeated its decision in the Sargent Case that the lessee was in no legal sense the purchaser of ore in place. Owing to the migratory, fugitive, and volatile character of oil and gas the rights and ownership therein are to be determined according to special rules and not according to the rules which prevail in the case of ore, coal and other solid minerals. (Ohio Oil Co. v. Indiana, 177 U. S. 190; Brown v. Spilman, 155 U. S. 665.) It may be that royalties upon oil and gas leases are for this reason distinguishable from royalties upon solid mineral leases, but the point has never been expressly determined with reference to the income tax.

45 Reg. 45, Art. 48.

46 See Chapter 26.

CHAPTER 19

INCOME FROM DIVIDENDS

The law expressly states that the gross income of a taxpayer shall include gains, profits and income derived from dividends.[1]

Definitions. The term "dividend," as used in the Revenue Act of 1918 (with one exception where it is used in connection with dividends paid by insurance companies on policy and annuity contracts) is defined therein to mean (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal-service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[2] Amounts distributed in the liquidation of a corporation are expressly required to be treated as payments in exchange for stock or shares, and any gain or profits realized thereby will be taxed to the distributee as other gains or profits.[3] It is to be noted that under this definition any distribution in the ordinary course of business, though extraordinary in amount, and other than a distribution in liquidation which is made by a corporation of earnings or profits accumulated since February 28, 1913, is a dividend; it need not necessarily be called a dividend. On the other hand, if the distribution is not out of earnings or

[1] Revenue Act of 1918, §§ 213 (a) and 234 (a) 10. The Revenue Act of 1916 provided that subject only to such exemptions and deductions as were thereinafter allowed, the *net* income of a taxpayer should include gains, profits and income derived from dividends (Revenue Act of 1916, § 2 (a)).

[2] Revenue Act of 1918, § 201 (a); Reg. 45, Arts. 1541 and 1543. It will be noted that the new definition, aside from its provision for personal service corporation distributions, omits the words, "or ordered to be made;" substitutes the word "accumulated" for "accrued;" and also expressly includes distributions made "in other property." See Revenue Act of 1916, § 31 (a), Reg. 33 Rev., Art. 106.

[3] Revenue Act of 1918, § 201 (c). Reg. 45, Art. 1548.

profits accumulated since February 28, 1913 (and prior to January 1, 1918, in the case of personal service corporations), it does not become a dividend within the meaning of the law by reason of the fact that it is called a dividend by the corporation making the distribution.[4]

Dividends on Life Insurance Policies. It is a custom of insurance companies to return each year a portion of the premium paid by the insured. The amount so returned is usually designated as a "dividend" and is either received in cash by the insured or applied by him to the reduction of the next annual premium. The law expressly provides that amounts received as a return of premiums paid by the taxpayer is not income.[5] Where, however, dividends are received on a paid-up policy their amount should be considered the same as dividends from corporations,[6] unless, of course, the dividend was not paid by the insurance company out of earnings or profits accumulated since the incidence of the tax.

Dividends from Associations. Since associations, joint-stock companies and insurance companies (whether incorporated or not) are treated as corporations and limited partnerships may be so treated,[7] the net earnings of such organizations when distributed should be considered dividends.[8] Thus, under the 1916 Law and former laws private banks, which had the form of corporate organization, were required to make returns as corporations, and the owners of the bank were authorized to treat as dividends the earnings which they received therefrom.[9] The recipient of profits of associations or limited partnerships should, therefore, ascertain whether the association or partnership is paying the tax as a corporation and in such event should treat any part of the net profits of the association received by him as dividends.

Dividends from Cooperative Associations. Dividends paid by cooperative associations, acting as sales agents for farmers or others, in the nature of a periodical refund or rebate to members or prospective members or patrons generally, are wholly dif-

4 Reg. 45, Art. 1541.
5 Revenue Act of 1918, § 213 (b) 2.
6 T. D. 2137.
7 See the discussion of limited partnerships in Chapter 8.
8 T. D. 2152.
9 T. D. 2137.

ferent from ordinary distributions based upon stockholdings and may be excluded from gross income by their recipients. Any profits of such associations made from non-members and distributed to members in the guise of rebates are, of course, subject to tax.[10]

DIVIDENDS FROM FEDERAL RESERVE BANK. Section 7 of the Federal Reserve Act of December 23, 1913, provides that federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Such exemption attaches to and follows the income derived from dividends on stock of federal reserve banks in the hands of the stockholders, so that the dividends received on the stock of federal reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations.[11]

DIVIDENDS AND INTEREST FROM FEDERAL LAND BANK AND NATIONAL FARM LOAN ASSOCIATION. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax.[12]

DISTRIBUTION IN LIQUIDATION. So-called liquidation or dissolution dividends are not dividends within the meaning of the statute, and amounts so distributed, *whether or not including any surplus earned since February 28, 1913*, are to be regarded as payments for the stock of the dissolved corporation. Any excess so received over the cost of his stock to the stockholder, or over its fair market value as of March 1, 1913, if acquired prior thereto, is a taxable profit. A distribution in liquidation of the assets and business of a corporation, which is a return to the stockholder of the value of his stock upon a surrender of his interest in the cor-

10 Reg. 45, Art. 522; T. D. 2737. See Chapter 13.

11 Reg. 45, Art. 76; Federal Reserve Bulletin, April 1, 1916.

12 Reg. 45, Art. 75; Reg. 33 Rev., Art. 86. Revenue Act of 1918, § 231 (13.)

poration, is distinguishable from a dividend paid by a going corporation out of current earnings or accumulated surplus when declared by the directors in their discretion, which is in the nature of a recurrent return upon the stock.[13]

[13] Reg. 45, Art. 1548. See also Reg. 45, Arts. 1541 and 1543. This ruling is founded largely upon the distinction drawn by the United States Supreme Court in the cases of Lynch v. Turrish, 247 U. S. 221, and Lynch v. Hornby, 247 U. S. 339. It is to be noted that the question in both these cases was whether earnings or profits accumulated prior to March 1, 1913, should be considered as dividends. The question was not: Shall earnings or profits accumulated *subsequent* to March 1, 1913, be considered as dividends? In determining the former question the Supreme Court drew a distinction according to whether or not the distribution was a dividend in ordinary course or a final dividend in liquidation. This distinction does not affect the answer to the second question. The issue in the Turrish and Hornby cases was whether certain earnings or profits were essentially *capital* or *income* for tax purposes, whether they were taxable as income or exempt as capital. On the other hand, the question arising in the interpretation of § 201 of the Revenue Act of 1918 pertains to the *character* of the taxability of certain earnings and profits. The Supreme Court did not hold in the Turrish case that corporate gains and profits accumulated prior to March 1, 1913, *are not* "dividends" if paid to a stockholder upon a winding up of the affairs of a corporation; it declared that such earnings or profits had become capital and were exempt therefore from tax when distributed. It did not hold in the Hornby case that corporate gains and profits accumulated prior to March 1, 1913, *are* dividends because they were paid to a stockholder by a corporation continuing in business or a going concern; it declared that such earnings or profits did not come into fruition as income *to the stockholder* until by virtue of an exercise of affirmative discretion on the part of the directors they were *declared,* that is, until they were separated from the corporation's general assets and the stockholder's interest was transformed from an inchoate and contingent interest in them to a definite and fixed share. It will be argued that a distribution which would have been a "dividend" under the Hornby case was held not to be a "dividend" in the Turrish case, solely because it was made upon the liquidation of the paying corporation and that therefore the essence of what would ordinarily be a "dividend" under the present law is changed by the same token. This argument is based upon the fallacy that the taxability of earnings or profits accumulated since the incidence of the tax is to be determined according to the same differentiation applying in the case of earnings or profits accumulated prior thereto. But, as stated above, the Turrish and Hornby cases divided on the question when, with reference to the incidence of the tax, a *distribution became income.* They did not settle the question: What kind of income are certain concededly taxable earnings or profits? The Court was not attempting in the Turrish and Hornby cases to distinguish between "dividends" and other distributions. It was drawing a line between capital and income, income received prior to March 1, 1913, having the status of capital.

Extent to Which Dividends Are Taxable. The extent to which dividends are taxable depends upon the status of the paying cor-

Although the Commissioner ruled in the Turrish case that the $79,975 representing the excess of the amount received by Turrish over the par value of his shares upon their surrender was income for the year 1914, this ruling was reversed by the district court, the circuit court of appeals (236 Fed. 653) and the Supreme Court. The reversal was not upon the express ground that the Commissioner had erred in taxing "dividends" as gains and profits, resulting from the sale of property, but such a decision was unnecessary in view of the court's more fundamental and sweeping conclusion that the dividends in question were not taxable at all, because they were capital. The Supreme Court did not decide that they were taxable *as ordinary gains or profits.* Such a decision would have been academic, if not inconsistent with its main conclusion. There is absolutely nothing in the Turrish case requiring the taxation of corporate earnings or profits accumulated subsequent to March 1, 1913, as gains and profits from the sale and exchange of property, except a ruling of the Commissioner which was completely set aside by the courts upon the most fundamental ground possible. Effect should be given, if possible, to the entire Revenue Act of 1918, and no part should be permitted to perish by construction. One part should not be allowed to defeat another part if by any reasonable construction the two can stand together (U. S. v. Ninety-Nine Diamonds, 139 Fed. 961). The Treasury Department's construction of subdivision (c) of § 201 seems to be a violation of this cardinal rule of statutory construction. The theory underlying the exemption of dividends from the normal tax is that the normal tax upon them had already been paid by the corporation declaring them. So far as the subject of any corporate distribution may represent earnings or profits accumulated subsequent to February 28, 1913, it has been subjected to the normal tax in the hands of the paying corporation. *So far as the normal tax is concerned,* it is capital, like the undistributed income of estates or trusts upon which the fiduciary has paid the tax. § 201 (c) seems clearly to be directed at another profitable element involved in a liquidation—the excess of the amount received upon a liquidation over the value of the stock on March 1, 1913 (or its cost if acquired subsequently thereto), *plus the earnings and profits accumulated* subsequently to February 28, 1913. This is a very different gain or profit from the taxable earnings or profits distributed. Moreover, it will be noted that the Revenue Act of 1918 uses the word "any" in Section 201 (a) 1. The word has just been carefully qualified by a parenthetical clause—"(except in ¶ (10) of subdivision (a) of § 234)". In view of the familiar meaning of the word "any" and the careful qualification immediately prior to it (which dismisses the possibility that Congress intended any further qualifications) in § 201 (a) 1, it becomes essential that § 201 (c) be read not as an exception, but as supplementary to § 201 (a), intended to reach another kind of possible profit than that contemplated in § 201 (a). Again, § 201 (c), as it stands, need not be construed as a qualification of § 201 (a). The phrase "other gains or profits" includes "dividends." (§ 213 (a)). In so far, then, as the gain or profit realized is a dividend it should be taxed as a dividend, that is, it should be

poration and upon the status of the recipient of the dividend.[14] As a general rule, income from dividends is subject only to the surtax, and, except in the case of certain stock dividends, is taxable at the rates in force in the year received.

DIVIDENDS PAID BY DOMESTIC CORPORATIONS. Dividends paid by a domestic corporation which is liable to income tax upon its net income or by a personal service corporation out of earnings and profits upon which income tax has been imposed, are not subject to the normal tax if received by an individual, the amount of such dividends being expressly allowed as a credit for the purpose of the normal tax.[15] If the recipient is a *non-resident alien* the credit of such dividends for purposes of the normal tax will be allowed only in case he files a true and accurate return of his total income received from all sources, corporate or otherwise, in the United States, in the manner prescribed by law.[16] If such dividends are received by a *corporation,* domestic or for-

subjected only to the surtaxes. Both the Turrish and Hornby cases were decided under the Act of October 3, 1913, which did not contain the definition of the term "dividend" to be found in the Revenue Act of 1916 and the present law. The Supreme Court admitted that its decision in the Hornby case would have been different had the 1913 Law contained any such definition. Two further rules of statutory interpretation would resolve any doubt remaining on this question. (1) The courts will avoid, if possible, any interpretation resulting in absurdity, inconsistency, glaring inequality or palpable injustice, giving effect to the spirit rather than the letter. (See Ch. 47.) (2) In the interpretation of statutes levying taxes it is also the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. (See Ch. 47.) If the mere fact that a distribution out of a corporation's earnings or profits accumulated since February 28, 1913, is made upon the liquidation of the corporation renders such earnings or profits liable a second time to the normal tax, the manner of distribution supplants the character of income as the decisive test of taxability. If a distribution made by a corporation out of its earnings or profits accumulated since February 28, 1913, is held to be a dividend only when made by a going corporation, the burden of the taxpayer is increased,—the taxpayer is subjected to an additional tax of 4 or 8% upon dividends received as a part of a liquidation. The clear import of the language used in § 201 does not require this—to say the least—and any remaining doubt should be resolved against the government and in favor of the citizen.

14 Revenue Act of 1918, § 201 (d).

15 Revenue Act of 1918, § 216 (a).

16 Revenue Act of 1918, § 217.

eign, the amount thereof is allowed as a deduction.[17] Dividends paid to non-resident alien individuals or to non-resident foreign corporations by domestic corporations doing no business or owning no property in the United States are not taxable at all.[18]

DIVIDENDS PAID BY PERSONAL SERVICE CORPORATIONS. Dividends paid by a personal service corporation out of earnings or profits upon which income tax has been imposed,—that is, earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918,—are taxable as stated in the preceding paragraph.[19]

DIVIDENDS PAID BY FOREIGN CORPORATIONS DERIVING NO INCOME FROM UNITED STATES SOURCES. Dividends paid by a non-resident foreign corporation[20] deriving no income from this country, if paid out of its earnings or profits accumulated since February 28, 1913, are subject, when received by a *citizen* or *resident* of this country, to both the normal and the surtax. When received by a *domestic corporation*, such dividends are subject to income and excess-profits taxes. When received by non-resident *aliens* or *foreign corporations*, they are subject to no tax, although they may be paid by the paying agent for the paying corporation at a place within the United States. No credit against net income is allowed individuals and no deduction from gross income is allowed corporations with respect to dividends received from a foreign corporation (foreign with respect to the United States) taxed in Porto Rico or the Philippines, but having no income from sources within the United States.[21]

DIVIDENDS PAID BY FOREIGN CORPORATIONS DERIVING INCOME FROM UNITED STATES SOURCES. The normal tax does not apply, regardless of their amount, to dividends received from a foreign corporation deriving income from sources within the United States, however small such income may be. Dividends from such corporations are treated in the same manner as dividends paid

17 Revenue Act of 1918, § 234 (a) 6 and (b). Under the 1913 Law corporations were not permitted to deduct amounts received as dividends from corporations subject to the income tax. This was likewise true of the 2% tax imposed by the 1916 Law, but for the purpose of the 4% tax imposed by the 1917 Law the amount of such dividends was permitted as a credit. (Revenue Act of 1917, § 3; Reg. 33 Rev., Art. 105.)

18 Reg. 45, Art. 92.

19 See Revenue Act of 1918, §§ 216 (a), 234 (a) 6, and 217.

20 For a definition of non-resident foreign corporation, see Chapter 12.

21 Reg. 45, Art. 1131.

by domestic corporations; that is, they are taken as a credit for the purpose of the normal tax by individuals and as a deduction by corporations, subject to the rule, that non-resident aliens and foreign corporations must make a true and accurate return of their total income received from sources, corporate or otherwise, in the United States.[22]

DIVIDENDS RECEIVED BY CITIZENS AND RESIDENTS. Dividends received by individuals who are citizens or residents of this country must be included in the return of income of the recipient; but for the purpose of assessing the normal tax, the amount of dividends received from the net earnings of any corporation taxable upon its net income, or from a personal service corporation, out of earnings or profits upon which income tax has been imposed, may, as indicated in the foregoing paragraphs, be taken as a credit. For the purpose of assessing the surtax no credit or deduction for such dividends will be allowed. The same rule applies where dividends are received by the estate of a deceased citizen or resident or by a trust estate created by a citizen or resident. The fact that an individual may not have legal title to the stock on which the dividends are declared does not alter the rule, if he is the actual beneficial owner. Therefore, the amount which may be received by a trustee in the form of dividends may be treated as dividends by the beneficiary in making his return; and similarly dividends received by a partnership are treated as dividends received by the partners, when the partners make personal returns of their net distributive shares in the profits of the partnership.[23]

DIVIDENDS RECEIVED BY NON-RESIDENT ALIENS. A non-resident alien is subject to the normal tax on dividends of corporations taxable upon their net income, or personal service corpora-

22 Revenue Act of 1918, §§ 216 (a) and 234 (a) 6. See T. D. 2090. Letter from Treasury Department dated June 9, 1919, I. T. S. 1919, ¶ 3427. This ruling supersedes the rule laid down for purposes of the excess-profits tax in 1917 to the effect that if a foreign corporation paid income tax on a part of its net income, its dividends should be treated, to that extent, as dividends of domestic corporations. Thus, if a foreign corporation paid income tax on half of its income, half of the amount of its dividends were credited for purposes of the normal tax when paid to individuals, and deducted when paid to corporations. (Reg. 41, Art. 27.)

23 T. D. 2090; Revenue Act of 1918, §§ 218 and 219. See U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27.

tions out of earnings or profits upon which income tax has been imposed, unless he files or causes to be filed a true and accurate return of his total income from all sources, corporate or otherwise, in the United States, in the manner prescribed for non-resident aliens. By so doing he is entitled to claim credit for the purpose of the normal tax on the amount of such dividends.[24] Although this credit may be enjoyed by a non-resident alien only by filing a return of income received from all sources, corporate or otherwise, in the United States, the normal tax is, nevertheless, not deducted at the source upon payments of dividends to non-resident aliens, since the section of the law providing for deduction at the source expressly declares that it shall not apply to income received as dividends from a corporation which is taxable upon its net income.[25] Dividends received by a non-resident alien from the net earnings of foreign corporations are not income from sources within this country, even though paid in this country.

Dividends Received by Corporations. Although a corporation must include in its gross income all dividends on the stock of corporations of which it may be a stockholder, it is entitled under the Revenue Act of 1918 to deduct amounts received as dividends from corporations taxable upon their net income, and amounts received as dividends from personal service corporations out of earnings or profits upon which income tax has been imposed.[26]

Dividends Received by Nominal Stockholders. When a dividend is received by one who is not the actual owner of the stock, but is the owner of record, he is not required to include the amount thereof in his own income tax return,[27] but proceeds in accordance with rules stated elsewhere in this book.[28]

[24] Revenue Act of 1918, § 217. See Revenue Act of 1916, § 6 (c), as amended by Revenue Act of 1917.

[25] Revenue Act of 1918, § 221 (a). See Revenue Act of 1916, § 9 (b), as amended by Revenue Act of 1917. Letter from Treasury Department dated June 4, 1918; I. T. S. 1918, ¶ 3452.

[26] Revenue Act of 1918, § 234 (a) 6. Under the 1913 and 1916 Laws dividends were taxable income to corporations. Under the 1917 War Income Tax Law dividends were not taxable income.

[27] Letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶ 272.

[28] See Chapter 5.

Presumption as to Source of Distribution. In the case of a corporation other than a personal service corporation any distribution to stockholders is deemed to have been made so far as possible (a) from earnings or profits; (b) during the year 1918 or thereafter from earnings or profits accumulated since February 28, 1913; (c), if during the first sixty days of a taxable year, from earnings or profits accumulated during preceding taxable years; and (d), if during the remainder of a taxable year after the first sixty days, from earnings or profits accumulated during the taxable year up to the date of distribution. The presumption contained in clauses (c) and (d) affects the determination of invested capital for the purpose of the war-profits and excess-profits tax, but has no effect upon the rates at which dividends paid in 1918 and subsequent years are taxed. In ascertaining whether or not a distribution was made out of earnings or profits of the taxable year there should first be set aside a proper reserve for the payment of accrued income and war-profits and excess-profits taxes. In the case of a personal service corporation any distribution is deemed to have been made so far as possible (a) from earnings or profits; (b) during the year 1918 or thereafter from earnings or profits accumulated since February 28, 1913; (c) if during the first sixty days of a taxable year, from the most recently accumulated earnings or profits of preceding taxable years; and (d) if during the remainder of the taxable year after the first sixty days, from earnings or profits accumulated during the taxable year up to the date of distribution.[29]

Dividends from Earnings or Profits Accumulated Prior to March 1, 1913. Any distribution will be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter will be deemed to have been made from earnings or profits accumulated since February 28, 1913, but any surplus accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.[30]

[29] Reg. 45, Art. 1542.

[30] Revenue Act of 1918, § 201 (b). Compare with Revenue Act of 1916, § 31, added by Revenue Act of 1917. See Reg. 45, Arts. 1542 and 1543. The conflict in the cases in the lower Federal courts under the 1913 Law, as to the

BOOK ENTRIES. In determining whether a distribution is made out of earnings or profits accumulated after or before March

taxability of dividends distributed subsequent to the incidence of the tax from earnings which accrued prior thereto (the law itself being silent on that point), has now been settled. In Lynch v. Turrish, 236 Fed. 653, it was held that a sum received by a stockholder in excess of the par value of his stock, exclusively from the increase in value of his stock prior to March 1, 1913, on account of the gradual advance of the value of the property of the corporation prior to that date, was not income when distributed by the corporation after the incidence of the tax. This decision was affirmed by the United States Supreme Court (247 U. S. 221). In Lynch v. Hornby, 236 Fed. 661, decided at the same time, the same lower court held that dividends received by a stockholder by the conversion of property into money and the distribution after the incidence of the tax, was not taxable where the dividend represented the value of property owned by the corporation on March 1, 1913, including the increase of the value of its timber lands and *surplus from its business operations*, the Court announcing that, in its opinion, no property held by the corporation or the stockholder whether original capital or previously earned surplus income, gains or profits, was intended to be made, or was made taxable as income by the 1913 Law, so far as it represented the value of such property on March 1, 1913. The Supreme Court reversed this decision, 247 U. S. 339, distinguishing the case from the situation in Lynch v. Turrish on the ground that the dividends to Hornby were not single and final, and did not represent the winding up or liquidation of the entire assets and business of the company, and a return to him of the value of his stock upon his surrender of his entire interest, and on the ground that Congress drew a distinction between a stockholder's undivided share or interest in the gains and profits of the corporation prior to the declaration of a dividend, and his participation in the dividends declared and paid; the Court proceeding on the theory that the stockholder is in the ordinary case a different entity from a corporation and that Congress was at liberty to treat dividends coming to him as constituting a part of his income when they came to hand, even though they might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. The court distinctly held that under the 1913 Law dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, *whether from current earnings or from a surplus accumulated prior to that date*, were taxable as income to the stockholder. See Skinner v. Union Pacific Coal Co., 249 Fed. 152. The case of Peabody v. Eisner 247 U. S. 347, followed Lynch v. Hornby in principle. In Southern Pacific Co. v. Lowe, 238 Fed. 847, the district court held that dividends from surplus accumulated prior to March 1, 1913, were not taxable if the surplus represented an increase in the value of the assets of the corporation, but were taxable if the surplus was accumulated from earnings or profits of the corporation prior to the incidence of the tax. This decision was reversed by the Supreme Court (247 U. S. 330), but only on the ground that the corporation which paid the dividend and the corporation which received it were in substance identical corporations, the stockholder,

1, 1913, due consideration must be given to the facts and mere book entries increasing or decreasing the surplus will not be conclusive.[31]

therefore, not being the ordinary stockholder contemplated in Lynch v. Hornby. See also Hays v. Gauley Mountain Coal Co., 247 U. S. 189; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195; Doyle v. Mitchell Bros., 247 U. S. 179; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71 and T. D. 2740; Trefry v. Putnam, (Mass.) 116 N. E. 904; State ex rel. Moon Co. v. Wisconsin Tax Commission, (Wis.) 163 N. W. 673 (now No. 387 on the United States Supreme Court Docket); Van Dyke v. Milwaukee, (Wis.) 146 N. W. 812, 150 N. W. 509; State ex rel. Pfister v. Widule, (Wis.) 163 N. W. 641; State v. Franklin Bank, 10 Ohio 91; Bailey v. Railroad Co., 22 Wall 603, 106 U. S. 109; Collecter v. Hubbard, 12 Wall 1.

31 Reg. 45, Art. 1543. Book entries of transactions between closely related corporations will be disregarded in favor of the facts in determining this question. Where a subsidiary company kept no bank account, but its earnings were deposited in the bank account of the parent company, which advanced the necessary funds whenever needed by the subsidiary for any operating expenses, or for additions or betterments, it was held that dividends, received by the controlling company and declared and paid during the first six months of 1914 out of surplus of the subsidiary company accumulated prior to January 1, 1913, and on such date consisting principally of a debit on the books of the subsidiary company, kept in accordance with the lease under which the controlling company operated the subsidiary company, were not taxable as income received in 1914 by the controlling company. It was also held that the time of the declaration or payment of the dividends was immaterial; that the declaration and payment thereof was a paper transaction to bring the books into accord with the acknowledged rights of the controlling company; that such dividends bore the appearance of accruing and in form only accrued to the controlling company after January 1, 1913; that, prior to such date, while the two companies were separate legal entities, yet in fact and for all practical purposes they were merged and identical, the subsidiary company being but a part of the controlling company, acting merely as its agent and subject in all things to its direction and control, the funds in question being in the actual possession and control of the holding company as well before as after the declaration. Southern Pacific Co. v. Lowe 247 U. S. 330. This case turned upon its very peculiar facts and is explained in Peabody v. Eisner, 247 U. S. 347. The doctrine of the above case has since been somewhat extended. Where a holding company, owning all the stock in several subsidiary companies except the qualifying shares held by directors which holding company and subsidiary companies constituted and were related as parts of a single enterprise of buying, transporting, refining and selling oil and which subsidiary companies had retained their earnings although making some loans *inter sese* and had invested in properties all their funds which were not actually required to carry on the business so that the debtor companies had no money to pay their debts, decided in January, 1913, to take over the previously accumulated earnings and surplus of such subsidiaries and actually did so in

Such Dividends Exempt Only to Stockholders of First Corporation. Under the 1916 Law it was held that where dividends had been paid from surplus accrued prior to March 1, 1913, they were free from tax in the hands of the stockholder, but if such stockholder was a corporation, upon the distribution to its stockholders of the sum so received as dividends, the fund became taxable to the stockholders of the second corporation as, to the holding company, such sum did not represent earnings or profits accrued prior to March 1, 1913. While the law provided for the exemption of dividends from corporate funds earned prior to March 1, 1913, it was held it did not provide for tracing the identity or character of such dividends after the receipt thereof by the stockholders of the corporation which earned the fund prior to the incidence of the tax.[32]

Dividends Received by an Estate. Dividends received by an estate are not exempt because paid from surplus accumulated prior to the creation of the estate, but are taxable either to the beneficiaries if the income is distributable, or to the estate if it is not distributable,[33] unless paid from earnings or profits accumulated by the corporation prior to March 1, 1913.

Dividends from Exempt Income. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed

1913 by votes of the subsidiaries, the court disregarded the forms gone through and the distinct corporate entities, and considered only the result which was that the holding company became the holder of the debts previously due from one subsidiary to another, was no richer than before, but its property, formerly represented only by stock in the subsidiaries, was thereafter represented by stock in *and debts due from* such subsidiaries. The changes having been effected by entries on the respective companies' books, the transaction was held to be a bookkeeping transaction and not a declaration and payment of dividends in the ordinary course by the subsidiaries. Although the holding company *did not itself do the business of the subsidiaries and have possession of their property*, the court nevertheless followed the principle of the case last discussed. (Gulf Oil Corporation v. Lewellyn, 248 U. S. 71.)

32 Letter from Treasury Department dated July 23, 1917; I. T. S. 1918, ¶ 284.

33 Letter from Treasury Department dated October 19, 1915; I. T. S. 1919, ¶ 1235. The principle of the decision in Matter of Osborne, 209 N. Y. 450 was referred to in this letter and held to have no application to the income tax law.

to stockholders in dividends is taxable to the same extent as other dividends.[34]

Distribution from Depletion or Depreciation Reserve. A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of its surplus out of which ordinary dividends may be paid. A distribution made from such a reserve will be considered a liquidating dividend and will constitute taxable income to a stockholder only to the extent that the amount so received is in excess of the cost or fair market value as of March 1, 1913, of his shares of stock. No distribution, however, will be deemed to have been made from such a reserve except to the extent that the amount paid exceeds the surplus and undivided profits of the corporation. In general, any distribution made by a corporation other than out of earnings or profits accumulated since February 28, 1913, is to be regarded as a return to the stockholder of part of the capital represented by his shares of stock, and upon a subsequent sale of such stock his profit will be the excess of the selling price over the cost of the stock or its fair market value as of March 1, 1913, after applying on such cost or value the amount of any such capital distribution.[35]

Distributions of Capital. Distributions of capital by corporations do not become income because they are called dividends. The reason why dividends paid out of earnings and profits accumulated prior to March 1, 1913 are free from tax is that such earnings and profits are assumed, for income tax purposes, to have the status of capital.

Dividends Taxable in Year Received. The mere declaration of a dividend is not a distribution. All dividends except stock dividends are taxable at the rates for the year in which paid regardless of when the earnings and profits out of which they were paid were accumulated.[36]

Dividends Paid in Equivalent of Cash. The Revenue Act of 1918 includes in its definition of the term "dividends" any distribution made by a corporation to its shareholders or members

[34] Reg. 45, Art. 1541; Reg. 33 Rev., Art. 4.

[35] Reg. 45, Art. 1549.

[36] Reg. 45, Arts. 31 and 1541; Letter from Treasury Department dated February 18, 1915; I. T. S. 1918, ¶ 271; Revenue Act of 1918, § 201.

whether in cash or in other property or in stock of the corporation.[37]

DIVIDENDS PAID IN PROPERTY. Dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation have been invested, are income to the recipients to the amount of the fair market value of such property when receivable by the stockholders. A dividend paid in stock of another corporation is not a stock dividend. Where a corporation declares a dividend payable in stock of another corporation, setting aside the stock to be so distributed and notifying the stockholders of its action, the income arising to the recipients of such stock is its fair market value at the time the dividend becomes payable.[38]

SCRIP DIVIDENDS. When a dividend is paid in scrip it is held to be equivalent to a payment in cash and an investment of the cash in the scrip. The dividend, therefore, must be included in the return at the face value of the scrip.[39] If at a later date the face value of the scrip is not realized in cash a loss may be claimed in the year in which the stockholder parts with the scrip. Scrip dividends are subject to tax in the year in which the warrants are issued.[40]

DIVIDENDS PAID IN LIBERTY BONDS. The fact that dividends are paid in Liberty Bonds does not exempt them from tax. When Liberty Bonds are used as a medium of payment, whether in discharge of a private debt or in payment of a corporate dividend, the profit or gain derived by the recipient is nevertheless subject to income tax.[41] The stockholder should make return of the

37 Revenue Act of 1918, § 201 (a). Although the 1916 Law in its definition of the term "dividends" expressly stated that a dividend should be a payment in cash or in stock of the corporation, that law did not seem to contemplate that no tax should accrue if the payment was made in the equivalent of cash.

38 Reg. 45, Art. 1544; Reg. 33 Rev., Art. 4. Letter from Treasury Department dated November 12, 1918; I. T. S. 1918, ¶ 3696. In Peabody v. Eisner, 247 U. S. 347, a case arising under the 1913 Law, a distribution in stock of another corporation was held not to be a stock dividend and was held to be taxable even though it partially represented surplus acquired prior to March 1, 1913.

39 Letter from Treasury Department dated January 19, 1915; I. T. S. 1918, ¶ 260. Scrip dividends were held taxable under the Act of June 30, 1864, Bailey v. Railroad Company, 22 Wall. 603, 106 U. S. 109.

40 Reg. 45, Art. 1544.

41 Letter from Treasury Department dated June 30, 1917; I. T. S., 1919,

dividend paid in Liberty Bonds on the basis of the cash value of the Liberty Bonds at the time of their receipt by him.[42]

CANCELLED DEBT TO BE CONSIDERED DIVIDEND. If a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of the payment of a dividend.[43]

TAXES PAID FOR SHAREHOLDERS TO BE CONSIDERED AS DIVIDENDS. Where a corporation, such as a bank, pays taxes assessed upon the respective interests of its shareholders, under laws which require the corporation to pay such taxes on behalf of its shareholders, the pro rata amount so paid on his shares should be reported by the stockholder as a dividend. The same amount may also be deducted as a tax of the stockholder paid for him by the corporation as his agent. The net result of reporting such amount as a dividend, and claiming the same amount as a deduction, is that the amount of tax is offset against the stockholder's income from other sources in assessing the normal tax.[44]

Dividends from Profits or Surplus of Prior Years. Under the 1916 Law, as amended, the rate of tax on dividends received in 1917 depended upon the year in which the amount distributed as dividends was earned by the paying corporation. The law provided expressly that the dividends should be a part of the annual income of the distributee for the year in which received, but should be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation.[45] The Revenue Act of 1918 provides "that if any *stock* dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period *bona fide* authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after

¶ 785; Letter from Treasury Department dated June 22, 1917; I. T. S. 1919, ¶ 848. The second of these letters is based upon an opinion on the subject obtained from the Attorney General by the Treasury Department. The question was raised by reason of the language of the Act authorizing the first issue of Liberty Bonds (Act of April 24, 1917, Public No. 3) which exempted the principal and income from taxation.

42 Letter from Treasury Department, dated November 12, 1918; I. T. S. 1919, ¶ 787.

43 Reg. 45, Art. 51.

44 For a further discussion of this subject see Chapter 24.

45 Revenue Act of 1916, § 31 added by Revenue Act of 1917.

the passage of this act, then such dividend shall in the manner provided in Section 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits."[46] All other dividends are taxable under the present law at the rates prescribed by law for the years in which they are received by the distributee.[47] The Revenue Act of 1918 also provides that "any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period."[48] This provision applies only to the determina-

[46] Revenue Act of 1918, § 201 (d). While this provision, read literally, would seem to tax stock dividends to a recipient *corporation* at the rate prescribed by law for the years in which the paying corporation accumulated the earnings or profits from which such dividends were paid—thus, for example, taxing dividends out of earnings or profits accumulated in 1917 at the rate of 2%—the provision must be read in connection with the section (Revenue Act of 1918, § 234 (a) 6), allowing the deduction of dividends when received by a corporation. Stock dividends will in no event be taxed to a recipient corporation in spite of the definition of the word "taxpayer" contained in the Revenue Act of 1918 (see Revenue Act of 1918, § 1). The provision is applicable only to the surtax applicable to individuals; in other words, the effect of the provision is that any stock dividend received by a tax-payer during the calendar year 1918 will be taxed, *only if it is taxable*, to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, the emphasis of the provision being on the words "at the rates" rather than the words "shall be taxed."

[47] Reg. 45, Art. 1641.

[48] Revenue Act of 1918, § 201 (e). The 1916 Law, as amended by the 1917 Law, expressly provided that any distribution made to stockholders in 1917, or thereafter, should be deemed to have been made from the most recently accumulated undivided profits or surplus. (Revenue Act of 1916, § 31 (b) added by Revenue Act of 1917; Letter from Treasury Department dated

tion of invested capital for purposes of the excess-profits tax and has no bearing on the income tax. By a special exception to the general rule any stock dividend received by a taxpayer between January 1 and November 1, 1918, or declared and credited to a stockholder during such period and received by him before March 27, 1919, is deemed to have been paid from the most recently accumulated earnings or profits and is taxed to the recipient at the rates prescribed for the years in which the corporation accumulated the earnings or profits so distributed. Thus, such a stock dividend will be deemed to have been paid from the earnings of 1918 (unless paid during the first sixty days of 1918), and the recipient, if an individual, will be liable to any surtax at the rates for the year 1918, unless at the time such dividend was paid or credited the current earnings up to that time were not sufficient to cover the distribution, in which case the excess over the earnings of the taxable year will be deemed to have been paid from the most recently accumulated surplus of prior years and will be taxed at the rate or rates for the year or years in which earned. A corporation declaring and paying such a stock dividend out of earnings accumulated over a period of years should make a record in its books of the amount of the dividend paid out of each year's undistributed profits and advise the stockholders accordingly.[49]

STOCK DIVIDEND SUBJECT TO RATES FOR DIFFERENT YEARS. The method of ascertaining the precise rate applicable to such portions of stock dividends received or credited in 1918 as are taxable at rates prescribed for previous years is as follows: The amount of the income of the recipient to which the 1918 rates are applicable is first ascertained. To such amount is then added the amount of income of the recipient liable to tax at the 1917 rates and the table of 1917 rates applied to see in which brackets such income falls. The income liable to 1916 rates is then added

February 9, 1918; I. T. S. 1918, ¶ 3099.) Under the 1916 Law, the Treasury Department ruled that dividends could be declared from any specified fund, that is, a dividend could be declared from surplus accumulated prior to March 1, 1913, and consequently be free from tax in the hands of the stockholders, although the corporation had surplus and undivided profits accumulated since that date sufficient to pay the dividend. This ruling is annulled by the amendment of October 3, 1917, except as indicated above.

49 Reg. 45, Art. 1546; Reg. 33 Rev., Art. 107; Letter from Treasury Department dated February 9, 1918; I. T. S. 1918, ¶ 3099; telegram from Treasury Department dated February 14, 1918; I. T. S. 1918, ¶ 3104.

and the table of 1916 rates applied to it. For instance, an individual has $20,000 of income liable to 1918 rates and $25,000 of dividends liable to 1917 rates. The total would be $45,000, of which $20,000 would be taxable at the 1918 rates and $20,000 to $45,000 at the surtax rates under the 1917 table applying to income over $20,000. In order that the correctness of the rates may be verified, taxpayers reporting stock dividends at other than 1918 rates will be required to render a statement at the time of filing their returns showing the corporations from which dividends taking other than 1918 rates were received, with the particulars of the dividends received from each.[50] Dividends of foreign corporations received by citizens or residents of the United States are to be apportioned to prior years, in the same manner as the dividends of domestic corporations.[51]

MOST RECENTLY ACCUMULATED EARNINGS OR PROFITS. The provision of the statute in regard to "most recently accumulated earnings or profits" has reference to the earnings or profits in existence at the time of the payment of the dividend, and not the time of declaration. In other words, the term "distribution" as used in the law, means the payment and not the declaration of dividends.[52] The language used in the 1916 Law was that the dividends "shall be deemed to have been declared from the most recently accumulated undivided profits or surplus," regardless of what the actual facts might be. Thus, the corporation might actually intend to make a distribution in the form of dividends out of some fund other than the most recently accumulated profits or surplus, but, nevertheless, the law deemed such payment to have

50 Reg. 45, Arts. 1641 and 1642.

51 Letter from Treasury Department dated March 14, 1918; I. T. S. 1919, ¶ 844 reversing telegram from Treasury Department, dated January 30, 1918; I. T. S. 1918, ¶ 3073.

52 Reg. 45; Art. 1541. The provision did not apply to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913. The Treasury Department held that if a dividend was declared prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913, such dividend would be deemed to be from the most recently accumulated profits or surplus unless the dividend was also paid prior to August 6, 1917. (Letter from Treasury Department dated February 9, 1918; I. T. S. 1918, ¶ 3099; telegram from Treasury Department dated January 31, 1918; I. T. S. 1918, ¶ 3069; telegram from Treasury Department dated July 5, 1918; I. T. S. 1918, ¶ 3592.)

been made from the most recently accumulated profits and surplus and the dividend was taxable on that basis. This was true even though such profits were invested in obligations of the United States issued after September 1, 1917, as the investment of earnings did not prevent them from being distributed as dividends.[53] It was immaterial what disposition had been made of the funds earned in the taxable year;[54] the net income as disclosed by the books as having accrued up to the date on which the dividends were paid was deemed to be distributed thereby.[55] In view of the difficulties which many corporations had in determining whether earnings in 1917 up to the date of dividend payment in that year were sufficient to cover the dividend paid, corporations were permitted to distribute the earnings for the accounting period for which the dividend in question was paid ratably over the period for the purpose of determining the amount of earnings during the period up to the date of payment.[56] In determining the source of earnings from which a particular distribution was made, a corporation was permitted to treat the undivided profits and surplus of the current year as reduced by payments for income and excess-profits taxes, or if keeping its accounts upon an accrual basis by proper reserves for such taxes, although such payments or reserves were not deductible in computing the income of the corporation for income and excess-profits taxes.[57] The language of the 1918 Law is substantially the same as that of the 1916 Law and the above rulings still apply.

Stock Dividends. The Revenue Act of 1918, expressly provides that stock dividends shall be taxable. It defines a stock dividend as a distribution made by a corporation, other than a personal service corporation, to its shareholders or members, in stock of the corporation out of its earnings or profits accumulated since February 28, 1913, or in the case of a personal service corporation any such distribution out of earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[58] It also pro-

53 Letter from Treasury Department dated May 27, 1918; I. T. S. 1919, ¶ 809.

54 Id.

55 T. D. 2659.

56 T. D. 2678.

57 T. D. 2700; T. D. 2736; Letter from Treasury Department dated May 13, 1918; I. T. S. 1919, ¶ 808.

58 Revenue Act of 1918, § 201 (a).

vides that a dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed.[59] A stock dividend is at most only taxable where a cash dividend would be taxable. Any distribution made in the form of a stock dividend, which would not be taxable if made in the form of a cash dividend, is not made taxable by reason of its distribution in the form of stock. Stock distributions, made out of surplus other than earnings or profits accumulated since February 28, 1913, when there are no such earnings or profits, are not dividends within the meaning of the statute and are free from tax as dividends. Stock dividends paid from earnings or profits accumulated after February 28, 1913, received by a fiduciary and retained as an accretion to the estate under the terms of the will or trust, are income to the estate.[60] It should be noted in connection with this discussion of the taxability of stock dividends that a stock dividend is a distribution by a corporation to its stockholders of capital stock of the distributing corporation. A distribution of capital stock other than that of the distributing corporation is not a stock dividend, but a dividend in property, or specie and is governed by the same rule applicable to the distribution of a like value in money.[61] As appears in a later paragraph, it has been held by a Federal District Court that the provision of the 1916 Law by which stock dividends were in terms stated to be income, and to be taxable as such to the same extent as are cash dividends, is unconstitutional.[62] The Treasury Department, however, will assess the tax on stock dividends until the point has been settled by the United States Supreme Court.

Rule Under 1916 Law. The 1916 Law expressly provided that stock dividends should be taxable. It defined a stock dividend as a distribution by a corporation out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders in stock of the corporation. It was provided that such stock dividends should be considered income to the amount of

59 Revenue Act of 1918, § 201 (c).

60 Reg. 45, Art. 1545.

61 Peabody v. Eisner, 247 U. S. 347. See T. D. 2740; Mimeograph Letter to collectors, No. 1795; I. T. S. 1918, ¶ 3107; Reg. 45, Art. 1544.

62 Macomber v. Eisner (U. S. Dist. Ct., So. Dist. of N. Y.) A decision from the United States Supreme Court is expected at an early date in this case.

the earnings or profits so distributed.[63] Notwithstanding the broad language in the opinion quoted at length in the following paragraph, the Treasury Department declared that since only the language of the 1913 Law and not the language of the 1916 Law was before the Court in that case, it did not necessarily follow that stock dividends were not taxable under the provisions of the 1916 Law and the 1917 Law, and that it would continue to be governed by the express provision in the 1916 Law taxing stock dividends, and would assess the tax on such dividends unless and until the Supreme Court held otherwise.[64]

Rule Under 1913 Law. The 1913 Law was silent as to stock dividends, and it was at first held by the Treasury Department that such dividends were not subject to tax, on the theory that the additional shares of stock issued to the stockholder represented no more than the same interest in the identical property represented by his stock before the dividend. The Treasury Department subsequently changed its attitude and held stock dividends to be the equivalent of cash and to constitute taxable income under the same condition as cash dividends.[65] As to the 1913 Law, this ruling of the Treasury Department has been reversed by decision of the United States Supreme Court in a case holding that stock dividends were not taxable. In that case[66] the Court said in part: "Notwithstanding the thoughtful discussion that the case received below we can not doubt that the dividend was capital as well for the purpose of the Income Tax Law as for the distribution between tenant for life and remainderman. What was said by this Court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interest of the shareholders. Its property is not diminished and their

63 Revenue Act of 1916, § 31, added by Revenue Act of 1917. The 1916 Law prior to the amendment contained substantially the same definition of stock dividends.

64 Letter to Collectors dated January 10, 1918; I. T. S. 1919, ¶ 811. In the opinion of the Treasury Department the Court did not decide that such dividends cannot be income within the meaning of the Sixteenth Amendment, but expressly recognized that the word "income" may have a different meaning in the Statute from the meaning in the Constitution.

65 T. D. 2274, dated December 22, 1915.

66 Towne v. Eisner, 245 U. S. 418.

interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons v. Mahon, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County v. United States, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change it certainly was not an advantage of $417,450, the sum upon which he was taxed. It is alleged and admitted that he received no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before. If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again if certificates for $1,000 par were split up in ten certificates, each for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.'' After this decision was rendered the Treasury Department announced that it would refund all taxes based on income from stock dividends reported by taxpayers under the 1913 Law, that is, for the years 1913, 1914 and 1915. In claiming such refunds the taxpayer was required to show by affidavit: (1) The name of the corporation which declared and paid the stock dividend; (2) The date of declaration of the stock dividend and date of receipt by claimant; (3) In which year's return of annual net income the claimant included the stock dividend; (4) Under what item on the return the value of the stock dividend was included, and what valuation was placed upon the dividend in the return; (5) Whether or not the stock thus received and returned as a dividend had been sold by the claimant, and if so, (a) the date of sale, (b) the amount claimant received therefrom, and (c) what part of the total amount received from the sale was included by the claimant in his return of annual net income for the year in which the sale occurred; and (6) whether or not the dividend consisted of stock of

the corporation distributing the dividend to claimant, or of stock acquired by the distributor in another corporation.[67]

CONSTITUTIONALITY OF TAXING STOCK DIVIDENDS WITHOUT APPORTIONMENT. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." The whole purpose of this amendment has been held to be to relieve income taxes, when imposed, from the requirement of apportionment; it in no way enlarged the power of Congress to levy income taxes.[68] It has been contended by the Treasury Department that the Supreme Court did not decide that stock dividends cannot be income within the meaning of the above constitutional amendment in the Towne case [69] referred to above, wherein it was held that stock dividends were not taxable under the 1913 Law, but expressly recognized that the word income may have different meanings, as used in the Statute and the Constitution.[70] On the other hand, it has been argued that the Supreme Court was not construing the 1913 Law in the Towne case, but was considering the broad question whether or not a stock dividend is fundamentally and essentially income within the meaning of that term as used in the Sixteenth Amendment; in other words, whether or not Congress has power under the Constitution to tax stock dividends without apportionment. In support of this argument it is urged that the Supreme Court was obliged to place its decision in the case of Towne v. Eisner upon constitutional grounds because of the Government's contention that under the sweeping language of the 1913 Law, stock dividends must have been considered taxable if they were income, and that a decision that they were not taxable was equivalent to a decision that they were not income. It is also to be noted in this connection that the dividends involved in the Towne case were from profits earned before January 1, 1913. The Supreme Court by a later decision [71] has removed the pos-

67 Mimeograph Letter to Collectors, No. 1795; I. T. S. 1918, ¶ 3107.

68 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

69 Towne v. Eisner, 245 U. S. 418.

70 Letter from Treasury Department to Collectors dated January 10, 1918, I. T. S. 1919, ¶ 811.

71 Lynch v. Hornby, 247 U. S. 339. In this case the Court held under the 1913 Law that dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, whether from current earnings

sibility that its decision in the Towne case was based upon this ground. The view that the decision denied the constitutional right of Congress to levy an income tax upon stock dividends has been adopted in a recent case in a lower federal court, decided under the 1916 Law, which expressly taxed stock dividends. The court in this case decided that the provision of the 1916 Law by which stock dividends are in terms stated to be income, and to be taxable as such to the same extent as are cash dividends, was unconstitutional because to impose an income tax upon stock dividends is to tax capital or principal, contrary to the requirement that direct taxes be laid by apportionment among the several states according to population.[72] Taxpayers against whom a

or a surplus accumulated prior to that date, were taxable as income to the stockholders. See also Peabody v. Eisner, 247 U. S. 347; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71; Southern Pacific Co. v. Lowe, 247 U. S. 330.

72 Macomber v. Eisner, (U. S. Dist. Ct., So. Dist. of N. Y.) decided January 23, 1919. See note 62. Judge Mayer overruled the demurrer of the Government to the complaint in this case upon the authority of Towne v. Eisner, 245 U. S. 418, and Peabody v. Eisner, 247 U. S. 347. In Trefry v. Putnam, (Mass.) 116 N. E. 904, the Court held stock dividends to be income. It said in part: "But the act of the corporation in 1916 was, in substance, a distribution of certificates of title to represent this increment of value with all the advantages that might flow therefrom. It was the issuance to the stockholder of a new thing of value transferable, transmissible, and salable separate and apart from that which before he had possessed. * * * In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which, instead of being paid out in cash, is invested in the business, and thus its durable assets augmented. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared, with the privilege of subscription to an equivalent amount of new shares. The stock dividend was declared strictly out of an accumulation of earnings applied to business uses, and not out of increased market value of capital investment. See Thayer v. Burr, 201 N. Y. 155, 94 N. E. 604. That which he had before was a fractional interest in the property of the corporation. So far as concerned the accumulation of profits, there was a possibility that they might be paid out in whole or in part as a cash dividend by authority of the corporation. By the issue of the stock dividend that possibility is gone, and the stockholder now has evidence of a permanent interest in the corporate enterprise of which he cannot be deprived. It is a thing different in kind from the thing which the stockholder owned before. From the viewpoint of the stockholder, he has received in the form of dividends in stock a thing with which theretofore he could have no tangible dealings. The certificates for the new shares of stock representing the stock dividend may have a materially greater value than the less tactile right to a share in the accumulated profits which he had before."

tax is assessed under the 1916 Law and the Revenue Act of 1918 on stock dividends should exercise care in paying the tax under protest and duress in order to protect their rights to recovery.[73] Where stock dividends are reported in the return of income, care should be taken that they are segregated from cash dividends and that it be clearly shown either on the return or on a rider attached to the return that the dividend was paid in stock and that the amount is reported not as an admission of liability for tax thereon, but out of courtesy to the Commissioner and in order to avoid the imposition of penalties for an alleged false or fraudulent return.

MONEY VALUE OF STOCK DIVIDENDS. The Revenue Act of 1918 provides[74] that dividends paid in stock of the corporation shall be considered income "to the amount of the earnings or profits distributed." The 1916 Law as amended by the 1917 Law, contained a substantially similar provision.[75] Prior to this amendment, the 1916 Law provided that a stock dividend should be taxable "to the amount of its cash value." The two phrases were construed to have the same meaning. A dividend paid in stock of the corporation is income to the amount of the earnings or profits distributed, as shown by the transfer of surplus to capital account on the books of the corporation, usually equal to the par value of the stock distributed. In the case of shares without par value the value of the stock for the purpose of taxation would be the amount of surplus transferred by the corporation to capital as a result of the dividend. Thus if a corporation declared a dividend of $100,000 from its surplus to be paid in one thousand shares of stock of the corporation the Treasury Department holds that each share received by the stockholders represented the equivalent of $100 of cash. It is immaterial that the market price of the stock so received is greater or less than the amount of surplus represented by the distribution.

Income Derived on Sale of Stock Received as Dividend. The question of the taxability of stock dividends refers only to their taxability at the time received. Under the 1913 Law, for example, a taxpayer may have received a stock dividend without being subject to any tax at the time of its receipt. If subsequently he

73 See Chapter 35 for the rules respecting payment under protest and duress.
74 Revenue Act of 1918, § 201 (c).
75 Revenue Act of 1916, § 31, as amended by the Revenue Act of 1917.

sells that stock the amount he receives may represent a profit or loss under the provisions of the law relating to sales or dealings in property. The rules for determining the profit or loss are affected by different considerations, accordingly as the stock dividends were received before or after the incidence of the 1916 Law. For the purpose of ascertaining the gain or loss derived from the sale of stock of a corporation received as a dividend, or from the sale of the stock in respect of which such dividend was paid, the cost (used to include also, where required, fair market price or value as of March 1, 1913) of such stock is to be determined in accordance with the following rules:

(1) In the case of stock (a) received as a dividend in 1913, 1914 or 1915 out of surplus however created, or (b) received as a dividend in 1916 or subsequent years out of surplus other than earnings or profits accumulated since February 28, 1913, the cost of each share of new stock is the quotient of the cost of the old stock divided by the number of old and new shares added together.

(2) In the case of the stock in respect of which any stock dividend was paid as described under (1), the cost of each share of old stock is similarly the quotient of the cost of the old stock divided by the number of old and new shares.

(3) In the case of stock received as a dividend in 1916 or subsequent years out of earnings or profits accumulated since February 28, 1913, the cost of each share of new stock is the quotient of the sum of (a) the cost of the old stock plus (b) the valuation at which the new stock was returnable as income (as shown by the transfer of surplus to capital account on the books of the corporation, usually its par value), divided by the number of old and new shares added together.

(4) In the case of the stock in respect of which any stock dividend was paid as described under (3), the cost of each share of old stock is similarly the quotient of the sum of (a) the cost of the old stock plus (b) the valuation at which the new stock was returnable as income, divided by the number of old and new shares.[76]

[76] Reg. 45, Art. 1547; T. D. 2734; Reg. 33 Rev., Art. 4, as amended by T. D. 2734. See also letter from Treasury Department dated October 30, 1916, I. T. S. 1918, ¶ 256. Letter from Treasury Department dated March 24, 1916, I. T. S. 1918, ¶ 257.

Stock Dividends Resulting from Revaluation of Assets. If a corporation has earnings or profits accumulated since February 28, 1913, any distribution will be deemed to be from such earnings until they have been distributed.[77] If a corporation has no earnings or profits accumulated after February 28, 1913, it may issue a stock dividend to distribute surplus created from the revaluation of capital assets or to represent value placed upon trademarks, good will, etc., and such dividends are not income to the shareholder. When stock received in payment of such a dividend, or stock in respect of which any such dividend was paid, is sold, the cost of each share of stock, whether old or new, for the purpose of ascertaining the gain or loss resulting from its sale, is the quotient of the cost of the old stock, if acquired on or after March 1, 1913, or its fair market price or value as of that date if acquired prior thereto, divided by the number of old and new shares added together. The profit so ascertained from the sale of such stock is income subject to both normal and surtax in the year in which the sale is made.[78]

[77] Letter from Treasury Department dated May 14, 1918; I. T. S. 1919, ¶ 801.

[78] T. D. 2734.

CHAPTER 20

RECEIPTS AND INCOME FROM MISCELLANEOUS SOURCES

After specifying a number of sources of income, the Revenue Act of 1918 provides that the gross income of the taxpayer shall include gains or profits and income derived from any source whatever.[1] In this chapter are set forth the rulings on income from sources not covered by the preceding chapters and on certain receipts which are not income.

Alimony. Alimony is not income, as it does not arise from any business transaction, and is not founded on any contract, but on the natural and legal duty of the husband to support the wife.[2] An allowance based on a separation agreement is also exempt from tax.[3] It follows that the husband cannot deduct amounts paid as alimony or an allowance paid under a separation agreement from his gross income for the purpose of the tax.[4]

Accident, Health or Workmen's Compensation Insurance. Amounts received through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are exempt from income tax whether the insured be alive or dead and whether received by him, his estate or other beneficiaries.[5] The amount of any damages received by

1 Revenue Act of 1918, 213 (a).

2 Gould v. Gould, 245 U. S. 151. This decision reversed the ruling of the Treasury Department on the point.

3 Reg. 45, Art. 73.

4 Reg. 45, Art. 291.

5 Revenue Act of 1918, § 213 (b) 6. Reg. 45, Art. 72. Accident insurance was first considered income (to the extent that it exceeded the aggregate premiums paid) but amounts received from a railroad company, by way of reimbursement for expenses incident to an accident were not income. These rulings were revoked, and it was held in pursuance of an opinion of the Attorney General (based upon Doyle v. Mitchell Brothers, 247 U. S. 179, affirming 235 Fed. 686; Lynch v. Turrish, 247 U. S. 221; and Southern Pac. Co. v. Lowe, 247 U. S. 330) that the proceeds of accident insurance policies received by an individual on account of injuries sustained by him through accident were not income under the 1916 Law as amended. (T. D. 2747.)

the individual injured or sick, if living, or his estate or other beneficiaries entitled to receive such damages, if dead, whether by suit or agreement, on account of such injuries or sickness is also exempt.[6]

Cancelled Debts. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect.[7] It may amount to a payment of income or to a gift or to a capital transaction.[8] Transactions involving the rendering of services in consideration of the cancellation of an indebtedness and the forgiveness of indebtedness between corporations and stockholders are treated elsewhere in this book.[9]

Allocation of Income from Judgments. Lands which are received as compensation for services in one year, the title to which is disputed and in a later day adjudged to be valid, constitute income to the grantee in the former year. On the other hand, a person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for a patent infringement. Bad debts or accounts charged off because of the fact that they were determined to be worthless and subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off.[10]

Compensation for Loss. In the case of property which has been lost or destroyed in whole or in part through fire, storm, shipwreck or other casualty, or where the owner of property has lost or transferred title by reason of the exercise of the power of requisition or eminent domain, including cases where a voluntary transfer or conveyance is induced by reason of the fact that a technical requisition or condemnation proceeding is imminent, the

6 Revenue Act of 1918, § 213 (b) 6; Reg. 45, Art. 72. Under the 1916 Law amounts received as the result of a suit or compromise for "pain and suffering" were at first held to be income. (T. D. 2135.) This ruling was subsequently revoked. (T. D. 2747.)

7 Reg. 45, Art. 51.

8 U. S. v. Oregon-Washington, etc. Co., 251 Fed. 211.

9 See Chapters 15 and 10.

10 Reg. 45, Art. 52. Letter from Treasury Department dated February 11, 1916; I. T. S. 1918, ¶ 1211.

amount received by the owner as compensation for the property may show an excess over the value of the property on March 1, 1913, or over its cost, if it was acquired after that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer.) The transaction is not regarded as completed at this stage, however, if the taxpayer proceeds immediately in good faith to replace the property, or if he makes application to establish a replacement fund as stated in the following paragraph. In such a case the gain, if any, is measured by the excess of the amount received over the amount actually and reasonably expended to replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments. The new or restored property effects a replacement in kind only to the extent that it serves the same purpose as the property which it replaces without added capacity or other element of additional value. Such new or restored property must not be valued in the accounts of the taxpayer at an amount in excess of the cost or value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer), of the original property, plus the cost of any actual additions and betterments. If the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the income will be measured by the excess of the amount of the compensation received over the cost of the property or its actual value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage or transfer). This ruling has no application to property which is voluntarily sold or disposed of.[11]

Replacement Fund for Loss. In any case in which the taxpayer elects to replace or restore the lost, damaged or transferred property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which the entire amount of the compensation so received shall be held without deduction for the payment of any mort-

11 Reg. 45, Art. 49, T. D. 2733. If the amount recovered was less than the damage sustained or less than an amount necessary to make good the damage, the difference between the actual amount of damage sustained and the amount recovered is deductible as a loss. (Reg. 33 Rev., Art. 94, as modified by T. D. 2706.)

gage, and pending the disposition thereof the accounting for gain or loss thereupon may be deferred for a reasonable period of time, to be determined by the Commissioner. In such a case the taxpayer should make application to the Commissioner on form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction, including the nature of the property, the character and extent of the loss, the manner and date of securing compensation, the date of acquisition of the property and its cost or fair value on March 1, 1913, the amount of compensation, the amount necessary to make the damage good, a description of the replacement intended and the steps already taken to that end, the probable date of compensation, the estimated additional excess-profits and income taxes assessable upon the income carried to the replacement fund, and all other matters which might affect a determination. He must undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require for an amount not less than the estimated additional income and war-profits and excess-profits taxes assessable by the United States upon the income so carried to the replacement fund. The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant and the surety or depositary may each have a copy. This ruling has no application to property which is voluntarily sold or disposed of.[12]

[12] Reg. 45, Art. 50; see Form 1114. Prior to the promulgation of this regulation, the taxpayer, at his option, might, in lieu of furnishing a bond as above indicated, deposit as security for the estimated additional amount of tax, obligations of the United States issued after September 1, 1917, such obligations to be held in trust in a bank or trust company approved by the Commissioner. (T. D. 2706.)

Income of Independent Contractor from State Contract. Any profit received from a State or political subdivision thereof by an independent contractor is taxable income. Where warrants are issued by a city, town or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the face value of such warrants must be returned as income. If for any reason the contractor upon conversion of the warrants into cash does not receive and can not recover the full face value of the warrants so returned, he may allowably deduct from gross income for the year in which the warrants are converted into cash any loss sustained.[13]

Increment to Sinking Funds. Where a sinking fund is set aside for the purpose of meeting obligations at a future date, all increment to that fund as a result of investments is income to the creator of the fund. Where a sinking fund, controlled by trustees, has been invested in the bonds of the corporation which created the fund, and the corporation pays the trustees interest on such bonds, the amount thereof may be deducted as if paid to any other bondholders, but the same amount must be included as income to the corporation from the sinking fund.[14]

Legacies. A legacy is a gift and the value thereof is not considered income to the recipient, but all income from the legacy is taxable. Unless clearly inconsistent with the intention of the testator, a legacy is held to be vested rather than contingent, and where there is a vested interest the income therefrom, whether distributed or not, is subject to the tax from the time of death of the testator, as income of the legatee.[15]

Pensions. Pensions and reitring allowances paid by the United States Government are subject to the income tax,[16] as also are pensions paid by any other government, or by any private interest, under any contract express or implied. If, however, a so-called "pension" is a mere gratuity or gift it is not taxable as income to the recipient.

Proceeds of Life Insurance. The proceeds of life insurance policies paid upon the death of the insured are exempt from tax under the Revenue Act of 1918 if paid to individual beneficiaries,

13 Reg. 45, Art. 37; Reg. 33 Rev., Art. 108.
14 T. D. 2161.
15 T. D. 2090.
16 Reg. 45, Art. 32; T. D. 2090.

directly or in trust, or to the estate of the insured, but not if to a corporation beneficiary.[17] If the proceeds are paid in installments under the terms of the policy none of the installments are subject to tax, but, it appears, if the proceeds are paid in installments by agreement between the beneficiary and the insurance company the installments are free from tax until they aggregate the amount of insurance payable on the death of the insured, and any amount in excess of that sum, due to deferring the payments, is income. Where an individual is the beneficiary it seems to be immaterial whether or not the premiums were paid by the insured or by the beneficiary, since the law grants an absolute exemption with respect to the proceeds of the policy. In the case of a corporation beneficiary of insurance taken out on the lives of officers or of employees the proceeds, less the total of any premiums paid thereon (and not deducted from net income in the year in which paid, as was permitted prior to the year 1917), is held to be income.[18] Since June 25, 1918, no assessment of any Federal tax may be made on any allotments, family allowances, compensation or death

[17] Revenue Act of 1918, §§ 213 (b) and 233 (a). Reg. 45, Art. 72. The 1916 Law provided that the proceeds of life insurance policies were exempt only when paid to an individual beneficiary upon the death of the insured, and not when paid to the estate of the insured. The Senate introduced a provision in the 1918 Revenue Bill to exempt the proceeds of life insurance policies regardless of to whom they were paid but the Conference Committee limited the exemption to proceeds paid only to individual beneficiaries or to the estate of the insured. In the vast majority of cases the difference between such proceeds and the premiums paid on the insurance represents the loss to a corporation in disturbance of its organization or impairment of good will occasioned by the death of the officer or employee insured. The proceeds of the policy over and above premiums paid in represents compensation for such loss and is in no true sense income. It is true that the exemption of such proceeds might render possible the evasion of the tax by the over-capitalization of the value of the insured's life and activities to the corporation, in which case, owing to the perpetuity of a corporation's existence, the policy would be an *investment*, perhaps similar to an endowment policy taken out by an individual. This mere possibility of tax evasion, however, does not justify the imposition of a hardship upon the well-run enterprise by the taxation *as profit* of what is essentially *compensation* for a definite and substantial loss. The Treasury Department first ruled that if the insurance proceeds are paid to a partnership they are not exempt income, but this ruling has now been withdrawn.

[18] Letter from Treasury Department dated March 15, 1918, I. T. S. 1918, ¶ 3290; Reg. 45, Art. 541.

or disability insurance payable under the War Risk Insurance Act of September 2, 1914, as amended, even though the benefit accrued before that date.[19]

Property Acquired by Gift. The value of property acquired by gift, bequest, devise or descent (but not the income from such property) is exempt.[20] Such property need not be reported as income by the recipient.[21] Money and real or personal property received as gifts, or received under a will or under statutes of descent and distribution, are exempt from tax, although the income therefrom derived from investment, sale or otherwise is not.[22] An amount of principal paid under a marriage settlement is a gift. Christmas presents, gratuities, voluntary contributions and donations are considered as gifts and should not be reported as income by the recipient. An exception, however, is made in the case of clergymen.[23] Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities.[24] Where the salary of an employee is paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no services being rendered by the recipient, the payments are gifts and exempt from taxation.[25] Of course, any amount paid by one person out of his income to another, as a gift, is not deductible from the gross income of the giver.

19 Reg. 45, Art. 72.

20 Revenue Act of 1918, §§ 213 (b) and 233.

21 Revenue Act of 1918, §§ 213 (b) 3,233 and 239. It was held under the 1913 Law that gifts to corporations were not exempt, but this ruling did not apply under the 1916 Law, since the provision of the 1913 Law exempting income of this character was contained in the subdivision applying particularly to individuals, while in the 1916 Law it was placed in a section having general reference to all taxpayers. Under the 1916 Law income of this character was exempt from the tax regardless of the status of the recipient. (Compare Revenue Act of 1916, § 4 with Act of October 3, 1913, ¶ B.) This is clearly the rule under the Revenue Act of 1918. (Revenue Act of 1918, §§ 213 and 233.)

22 Reg. 45, Art. 73.

23 See Chapter 15.

24 Reg. 45, Art. 107. For a discussion of so-called gifts which are in fact payment for services see Chapter 22.

25 T. D. 2090; Reg. 33, Art. 6.

Rights to Subscribe to Stock. Where a stockholder acquires the right to subscribe to new stock of the corporation and sells that right, the amount received is income.[26] If he exercises the right, no income accrues until the stock subscribed for is sold.

Stock Received as Bonus. Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price must be fairly apportioned between the stock and securities purchased for the purpose of determining the portion of the consideration attributable to each class of stock or securities and so representing its cost, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.[27]

Sale and Retirement of Corporate Bonds. If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If thereafter, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year. If bonds are issued at a premium, the net amount of such premium is gain or income which should be pro-rated or amortized over the life of the bonds. If the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned

26 Letter from Treasury Department dated February 27, 1915; I. T. S. 1918, ¶ 420; Reg. 45, Art. 39. In Trefry v. Putnam, (Mass.) 116 N. E. 904, in which the Court held that gains derived from a sale of rights to subscribe for new shares of stock were taxable as income under the Massachusetts Income Tax Law, the Court said in part: "Such rights are themselves a species of intangible property. They come to the stockholder as a gratuity. They are a new thing of value which he did not possess before. The amount for which he sells them is a gain. * * * They are not regarded ordinarily as a profit from the prosecution of the business, but are an inherent and constituent part of the shares. * * * Their sale resulted from an exercise of judgment to that effect on the part of the stockholder. They are indistinguishable in principle from a sale of the stock itself, and gains derived from sales of such rights fall within the same class of income. The statute in this regard is not in conflict with the amendment."

27 Reg. 45, Art. 39.

as income) over the purchase price is gain or income for the taxable year. If bonds are issued by a corporation at a discount and the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.[28]

Dividends on Life Insurance Policies. Dividends paid on life insurance policies that have not matured, whether or not such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income. Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. The former represent merely a return of a part of the premium theretofore paid by the insured, while the latter represent a distribution of income earned by the insurance companies on the premiums paid by the insured.[29]

Surrender Value of Insurance Policies. When an insured person discontinues insurance prior to the maturity of his policy, he is entitled to a certain surrender value which is paid to him by the insurance company. The amount so received represents the return to the insured of a part of the premiums he has paid in the past, and is therefore not income. If the amount should exceed the aggregate of premiums paid, the excess would be taxable income.[30]

Endowment Policies. Where an endowment policy is paid to the insured, it is exempt from tax to the extent that the payment represents a return without interest, to the insured of amounts paid by him from time to time as premiums, but is taxable on the excess.[31] Thus, if over a period of years the insured has paid $700 in premiums, and, at the expiration of the terms receives

[28] Reg. 45, Art. 544. See p. 354.

[29] Reg. 45, Art. 47; T. D. 2137.

[30] Revenue Act of 1918, § 213 (b) 2; Reg. 45, Arts. 47 and 72; T. D. 2090; T. D. 2152; Letter from Treasury Department dated February 8, 1917, I. T. S. 1919, ¶ 949.

[31] Revenue Act of 1918, § 213 (b) 2; Reg. 45, Arts. 47 and 72; T. D. 2090; T. D. 2152.

$1,000 from the insurance company, $300 of that sum is taxable income, but the $700, representing return of premiums, is not income.

Annuities. The Revenue Act of 1918 provides that the amount received by the insured as a return of premiums paid by him under life insurance, endowment or annuity contracts either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract is exempt from taxation.[32] Under this provision of law the Treasury Department has ruled as follows: Annuities paid by religious, charitable and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as taxable income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. Where an insured receives under life insurance, endowment or annuity contracts, sums in excess of the premiums paid therefor, such excess is income for the year of its receipt.[33]

Shares in Building and Loan Association. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. Where the amount of such accumulation does not become available to the shareholder until the maturity of a share, the amount of any share in excess

[32] Revenue Act of 1918, § 213 (b) 2.

[33] Reg. 45, Art. 47. Under the 1913 Law it was held that the amount by which the sum received exceeded the sum paid and coming into the hands of the person making the contract and payment was income. It was also first held that "when the settlement under such contract and payment is made in more than one payment each payment will be considered as being composed of interest and a proportionate part of the principal." and "where the entire annuity is composed of an interest return upon the principal sum paid therefor, the entire annuity is income." (T. D. 2090.) The matter quoted, however, was afterward stricken out of the ruling. (T. D. 2152.)

of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.[34]

Compensation by Insurance. Insurance money is clearly a substitute for the assets lost or destroyed. If the insurance money is in excess of the cost of the property it may be used to restore the property or be placed in a fund for that purpose for a reasonable time until restoration can be made, final accounting for tax on the excess over the amount actually and reasonably expended to replace or restore the property substantially in kind, being deferred until the restoration or replacement has taken place. If the taxpayer does not elect to restore the property the transaction will then be deemed to be completed. The rulings applicable in either alternative have been given in the earlier part of this chapter.[35]

Taxes on Profits from Sale of Property Paid by Vendee. In a case where the vendee of a business agrees that in addition to the purchase price he will pay the income and excess-profits taxes of the vendor arising from the sale of such business, it has been ruled that such taxes paid by the vendee constitute additional taxable income to the vendor.[36]

Tax Paid by Debtor on Account of Tax-Free Covenant Bond. Where a debtor corporation, in pursuance of a tax-free covenant clause in its bonds pays the 2% normal tax, the amount of the tax paid by the corporation is income to the bondholder. The obligor, in pursuance of a contract voluntarily entered into, guarantees to pay a direct liability of the taxpayer which consists in paying a certain amount of normal tax for him to the Government. The reduction of the payment of his tax liability under such a contract constitutes income to him by reducing his expenditures in that amount. The fact that the amount of the liability was paid direct to the Government instead of to the taxpayer, does not preclude such an amount from constituting income to the taxpayer.[37]

[34] Reg. 45; Art. 54. Letter from Treasury Department dated February 8, 1917; I. T. S. 1919, ¶ 949.

[35] See p. 321.

[36] Telegram from Treasury Department dated May 2, 1919; I. T. S. 1919, ¶ 3322.

[37] Letter from Treasury Department dated September 13, 1919; I. T. S. 1919, ¶ 3567.

CHAPTER 21

DEDUCTIONS—IN GENERAL

Certain deductions are specified in the law for computing the net income of an individual or a corporation.[1] The Revenue Act of 1918 also expressly provides that certain items shall not be deductible in the case of both individuals and corporations.[2] While the deductions allowed corporations and individuals are based upon the same principles, they vary in some particulars, because of differences in the status of these two classes of taxpayers. Thus, an individual may deduct charitable contributions or gifts made within the taxable year, while no corresponding deduction is allowed to corporations. The separate provisions made in the case of individuals for the deduction of losses sustained in any transaction entered into for profit though not connected with trade or business, and losses of property not connected with trade or business, if arising from fires, storms, etc., have no counterparts in regard to corporations, since a corporation's transactions are all entered into for profit and are connected with its business. All losses of a corporation may therefore be deducted. Certain special deductions are allowed in the case of insurance companies which are not necessary in the case of individuals, and other kinds of corporations.[3] Dividends from a corporation taxable upon its net income, and from a personal service corporation out of earnings or profits upon which income tax has been imposed are allowed as a deduction to corporations and to individuals only as a credit for the purpose of the normal tax. The general effect of the Revenue Act of 1918 as compared with preceding laws is to place individuals and corporations more nearly upon the same footing in regard to deductions. In the case of non-resident aliens and foreign corporations the deductions are intended in general to be limited to expenses, losses, etc., paid or incurred in the crea-

[1] Revenue Act of 1918, §§ 214 and 234.

[2] Revenue Act of 1918, §§ 215 and 235.

[3] These deductions are specially treated in Chapter 11.

tion of income taxed by this Government.[4] The special provisions applicable to individuals, corporations, non-resident aliens and foreign corporations are set forth in the chapters dealing respectively with those subjects. The general provisions and principles applicable to all taxpayers are discussed in this and the following chapters.

Only the Deductions Specified in the Statute Are Allowed. Although the tax is imposed on the "net income" of a taxpayer, yet the term "net income" is used as defined in the statute, and not as known generally in accounting practice. Some deductions dictated by prudence and good business management are not recognized or countenanced by the law. Only those deductions which are expressly specified in the statute may be taken for income tax purposes. It may be observed that the present law, to a greater degree than any preceding law, follows the lines of commercial usage in defining net income.[5]

Deductions Must Be Actual. The deductions specified in the statute can be deducted by the taxpayer only when they represent actual payments or actual liabilities. It is not permissible, for instance, for a taxpayer owning the property used and occupied for his or its own business purposes to include as a deduction the rental value of the property so owned. Neither is it permissible to deduct an amount representing the interest which might be earned on the capital employed in the business, if such capital were invested or employed otherwise, or were so placed as to earn a given rate of interest.[6] The deductions claimed must ordinarily be those represented by actual cash disbursements unless the taxpayer keeps his books on some other basis than that of actual receipts and disbursements.

Deductions Not to Be Duplicated. Where a deduction may, or should be, claimed as one of the items specifically stated in the law, such deduction should not also be included under another head. Thus, where a deduction is claimed as depreciation or as a loss, the same amount should not also be deducted as a business expense, or if the cost of tools or small articles has been charged

[4] See Chapters 4 and 12.

[5] One notable variation even in the present law as construed by the Treasury Department is the treatment of corporate organization expenses. See p. 149.

[6] T. D. 2137.

to expense, depreciation should not be claimed thereon, as this would be claiming the same deduction twice. Interest paid by a corporation constitutes a separate deduction and should not be taken into account as a part of the cost of manufacture.[7]

Income and Deductions Reported on Same Basis. Net income means gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. The surtax is imposed upon net income; the normal tax upon net income less credits. Though taxable net income is wholly a statutory conception it follows, subject to certain modifications as to exemptions and as to some of the deductions, the lines of commercial usage. Subject to these modifications statutory "net income" is commercial "net income."[8] Deductions are to be reported when the amounts claimed therefor are "paid or incurred" or "paid or accrued" on the books of the taxpayer; that is, when they are actually paid or become a fixed liability according to the method of accounting employed by the taxpayer. In other words, net income is computed on the basis of actual receipts, or on the basis of accrued receipts. Deductions must be claimed on the same basis as that upon which gross income is reported. They must usually be claimed for the year in which the income with the production of which they are connected is reported. The taxable year as a unit of time applies to both gross income and deductions.

Deductions in the Equivalent of Cash. It is not always necessary that an amount claimed as a deduction be paid out in cash. Just as income may be received in kind or in the equivalent of cash, so deductions may be represented by payments in some form other than actual cash. For instance, it was held under the 1913 Law that commissions allowed salesmen and paid in stock might be deducted as expense, if so charged on the books of the corporation, at the actual value of such stock.[9]

When Charges Deductible. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every

[7] T. D. 2137.
[8] Reg. 45, Art. 21.
[9] Reg. 33, Art. 117.

reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return.[10]

Contributions to Charities. A citizen or resident is allowed to deduct from his net income contributions or gifts actually made within the taxable year to corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by the Vocational Rehabilitation Act. A gift to a common agency (as a war chest) for several such corporations or associations is treated like a gift directly to them. This deduction, however, is limited to an amount not in excess of 15 per cent of the taxpayer's net income including the amount of such contributions. The law further provides that such contributions or gifts shall be allowable as deduc-

[10] Reg. 45, Art. 111.

tions only if verified under rules and regulations prescribed by the Treasury Department.[11] In connection with a claim for this deduction the following information is required to be stated on returns of income: (a) The name and address of each organization to which a gift was made. (b) The approximate date and amount of the gift in each case. Where the gift is other than money, the basis for calculation of the value of the gift should be the fair market value of the property the subject of gift at the time of the gift. The donor is not required to report as a profit the excess in value of the property donated, over its cost or fair market value on March 1, 1913.[12] A gift of real estate to a city to be maintained perpetually as a public park is not an allowable deduction.[13] Donations made by a partnership may be prorated among the individual partners for the purpose of their individual income tax returns.[14] This deduction is not allowed to corporations.[15]

Items Not Deductible. Certain items are expressly declared not to be deductible in computing net income.

PERSONAL, LIVING OR FAMILY EXPENSES. In computing net income no deduction is allowed in respect of personal, living or family expenses.[16] These expenses may be said to be covered by the arbitrary sum allowed as a personal exemption. Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives there clients, patients or callers in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part

11 Revenue Act of 1918, § 214 (a) 11; Reg. 45, Art. 251.

12 Letter from Treasury Department dated August 14, 1919; I. T. S. 1919, ¶ 3550.

13 Reg. 45, Art. 251. See also Reg. 33 Rev., Art. 8.

14 Letter from Treasury Department dated May 23, 1918; I. T. S. 1919, ¶ 1296.

15 Thus, Red Cross contributions are not deductible by corporations (T. D. 2847; Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436). Contributions are allowed to corporations, however, in some cases when they have consideration in some form so as to take them out of the class of gratuities. See Chapter 22.

16 Revenue Act of 1918, § 215 (a).

of the house for his office, such portion of the rent as is property attributable to such office is deductible. The father is legally entitled to the services of his minor children, and allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions. Alimony and an allowance paid under a separation agreement are not deductible from gross income. The cost of the equipment of an army officer to the extent only that it is specially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not.[17]

TRAVELING EXPENSE. Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, such railroad fares are personal expenses and such meals and lodging are living expenses. If the trip is on business, the railroad fares become business instead of personal expenses, but the meals and lodging continue to be living expenses and are not deductible in computing net income. If, then, an individual whose business requires him to travel receives a salary as full compensation for his services, without reimbursement of traveling expenses, his expenses for railroad fares, but not for meals and lodging, are deductible from gross income. If such an individual receives a salary and is also repaid his actual traveling expenses, no part of such expenses is deductible from gross income and no part of such repayment is returnable as income. If such an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, any excess of the cost of such meals and lodging over the allowance is not deductible, but any excess of the allowance over the actual expenses is taxable income. Congressmen and others who receive a mileage allowance for railroad fares should return as income any excess of such allowance over their actual expenses for such fares. A payment for the use of a sample room at the hotel for the display of goods is a business expense.[18]

17 Reg. 45, Art. 291. The same rule was followed under the Civil war income tax laws in regard to the services of minor children. (7 Int. Rev. Rec. 60.)

18 Reg. 45, Art. 292. See In re. Assessment of Taxes of T. A. Hayes, 16 Haw. 796; Galm v. U. S., 39 Ct. Cls. 55.

IMPROVEMENTS AND BETTERMENTS. The Revenue Act of 1918 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate.[19] Amounts expended for additions and betterments add to the value of the property and are considered as a capital investment.[20] If expenditures are made for permanent improvements and betterments they are treated as any other investment of capital; that is, if the asset in which the capital is invested is one on which depreciation may be claimed, the amount expended for the permanent addition or betterment is added to the cost of the property for the purpose of determining the annual depreciation allowance thereafter. The statute merely intends to prohibit the deduction of the entire amount in the year in which the expenditure is made.

EXAMPLES OF CAPITAL EXPENDITURES. The following have been held[21] to be investments of capital and not deductible business expenses: (a) amounts expended for securing copyright and plates which remain in the possession of and the property of the person making the payments; (b) the cost of defending title or perfecting title to property;[22] (c) amounts expended for architect's services;[23] (d) commissions paid in purchasing and selling securities;[24] (e) amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation; (f) an assessment paid by a stockholder of a national bank on account of his statutory liability; (g) expenditures of a railroad for sidings and spur tracks.[25]

PUBLIC UTILITIES. In a decision under the 1909 Law it was held that the fact that, under the laws of California, a public utilities corporation is not the owner of the property, but merely

19 Revenue Act of 1918, §§ 215 (b) and 235.

20 Reg. 33, Art. 118.

21 Reg. 45, Art. 293; Reg. 33 Rev., Art. 8.

22 Such cost constitutes a part of the cost of the property.

23 Such amounts are a part of the cost of the building.

24 Such commissions are part of the cost or offset against the selling price of the securities.

25 Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

intrusted with the use thereof, did not entitle it to more favorable treatment than other corporations. Money received from the consumers to pay for service connections to be laid in public streets was held to be income on which the corporation was liable to pay a tax, notwithstanding that all or nearly all of the sums so received may have been expended in betterments and extension of its system. Moneys expended for service connections and pipe extensions are invested in permanent improvements, and do not come within any of the permitted classes of deductions mentioned in the statute.[26] They are not in the nature of improvements made merely to facilitate the transaction of a growing business, the expenses of which have been held deductible.[27]

EXPENSE OF RESTORING PROPERTY. The Revenue Act of 1918 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of any amount expended in restoring property or in making good the exhaustion thereof on which an allowance is or has been made.[28] This is also a reasonable limitation since if such property is subject to wear or tear and depletion, the additional amount so invested in the property may be taken into consideration in computing the allowance for depreciation and depletion.

INSURANCE ON EMPLOYEES. No deduction is permitted for any amount paid in premiums on any life insurance policy covering the life of any employee or any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.[29] But if the taxpayer is in no sense a beneficiary under such a policy, except as he may derive advantage from the increased efficiency of the employee, and pays the premiums purely as reasonable additional compensation of such employee, they are allowable deductions. The question whether the proceeds of such policies paid upon the death of the insured may be excluded from gross income or must be included therein depends upon whether the beneficiary is an individual or a corporation.[30]

26 Union Hollywood Water Co. v. Carter, 238 Fed. 329.

27 See Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

28 Revenue Act of 1918, §§ 215 (c), 235.

29 Revenue Act of 1918, §§ 215 (d), 235. See p. 324.

30 Reg. 45, Art. 294.

Special Assessments Against Local Benefits. Although assessments against local benefits are frequently referred to as taxes, and are imposed by local governments, they are not deductible as taxes, if "of a kind tending to increase the value of the property assessed."[31] The quoted words were added by the Revenue Act of 1918. Under the 1916 Law, which did not contain this provision, such assessments as, for instance, for paving, curbing, installing sewerage and water systems, etc., were held to be expenditures which add to the value of the property and should be capitalized, that is, added to the cost of the property for the purpose of determining the loss or gain in a subsequent sale of such property.[32]

31 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

32 Letter from Treasury Department dated December 22, 1914; I. T. S. 1919, ¶ 1883.

CHAPTER 22

DEDUCTION OF BUSINESS EXPENSES

The Revenue Act of 1918 permits to corporations the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.[1] The law permits to individuals the same deduction, except that the property with respect to which rentals, or other payments required to be made, may be deducted, must be used "for purposes of the trade or business" carried on by the individual.[2] The deduction of business expenses is allowed in the case of non-resident aliens and non-resident foreign corporations if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of their deduction with respect to sources of income within and without the United States must be determined under the rules and regulations prescribed by the Commissioner with the approval of the Secretary.[3] The special provisions applicable to non-resident

1 Revenue Act of 1918, § 234 (a).

2 Revenue Act of 1918, § 214 (a) 1.

3 Revenue Act of 1918, §§ 214 (b) and 234 (b). The 1916 Law permitted to individuals the deduction of the "necessary expenses actually paid in carrying on any business or trade," (Revenue Act of 1916, § 5 (a)), and in the case of corporations all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken, or is not taking, title or in which it has no equity." The Revenue Act of 1918 further qualifies the expenses deductible as stated in the text above by stipulating that they all be "ordinary" as well as "necessary," allows their deduction if "incurred" as well as "paid" omitting the word "actually" in connection with the word "paid." (Revenue Act of

aliens, and domestic corporations and foreign corporations are discussed in the chapters on these subjects. The discussion in this chapter is limited to the rules applying generally to all taxpayers. As a general rule, the expenses which may be deducted are those necessary for the creation of the income which is taxed. It should be noted, however, that the language of the law contains some express limitations, which are more fully discussed in the following paragraphs.

Business Expenses. Business expenses, whether subtracted from total receipts in computing gross income or deducted from gross income in computing net income, include all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses. Among the items to be treated as business expenses are material, labor, supplies and repairs in the case of a manufacturer, while a merchant would include his purchases of goods bought for resale. In either case the amount to be taken as a deduction in any year should be determined by taking into consideration the inventory at the beginning and end of the year. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business, and rental for the use of business property. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source.[4]

1916, § 12 (a).) In the case of non-resident aliens the deduction was limited to business conducted within the United States and in the case of foreign corporations to business and property within the United States.

[4] Reg. 45, Art. 101. The 1916 Law permitted the deduction by corporations of "all the ordinary and necessary expenses paid * * * in the maintenance and operation of its business and properties." The 1918 Law permits the deduction by corporations of "all the ordinary and necessary expenses paid * * * in carrying on any trade or business," which seems to be a broader phrase than that used in the 1916 Law. (Compare Revenue Act of 1916, § 12 (a) with Revenue Act of 1918, § 234 (a) 1.) Expenses of operation were held under the 1916 Law to include all expenditures for material, labor, fuel, and other items entering into the cost of the goods sold or inventoried at the end of the year, and all other expenses incurred in the operation of the business, except such as were required by the act to be segregated in the return (Reg. 33, Art. 114), or had been considered in determining the cost

Professional Expenses. A professional man may claim as the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the expense of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts expended for books, furniture and professional instruments and equipment of a permanent character are not allowable as deductions.[5]

RENT FOR RESIDENTIAL PROPERTY. In the case of a professional man who rents property for residential purposes but receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere) no part of the rent is deductible as expense.[6]

Cost of Manufacturing Products. A manufacturer might, under the 1916 Law, include as elements of the cost of manufactured products, the cost of raw material, the labor cost of the men actually working on such products, as well as the cost of supervisory labor such as that of foremen, inspectors, overseers, etc., provided such expenditures were not separately deducted from gross income.[7] This ruling permits certain items of wages and salaries to be included in the cost of the manufactured product, or to be separately listed as labor, wages, commissions, etc.

Cost of Materials. Taxpayers carrying materials and supplies on hand should deduct as expenses the charges for materials and supplies only to the amount that they are actually consumed and used in operation during the year for which the return is made, provided that the cost of such material and supplies has not been taken into account in determining net income for any previous year.[8] If a taxpayer carries materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to deduct from gross income

of purchases during the year. Payments for labor and materials going into the actual operating of a railroad and its properties were deductible. (Grand Rapids, etc., Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.)

5 Reg. 45, Art. 104.

6 Reg. 33 Rev., Art. 8.

7 T. D. 2152.

8 Reg. 33 Rev., Art. 130.

as expenses the total cost of such supplies and materials as were purchased during the year for which the return is made, provided the net income is clearly reflected by this method.[9]

Repairs. Incidental repairs made to the business property of a taxpayer, which neither add to the value of the property nor appreciably prolong its life, but keep it in an operating condition, are deductible as expense, provided the plant or property account is not increased by the amount of such expenditures.[10] Expenditures for replacing worn out parts such as gears, bolts, nuts, valves, etc., so long as such replacements are not pursued to the extent of, and for the purpose of finally restoring the machinery or equipment as a whole, constitute incidental repairs and are deductible as operating expenses. In addition, depreciation on the property so repaired may be claimed in order to replace the machinery, equipment or building when, as an entirety, it is worn out or is worthless for the purpose for which it is intended.[11]

IMPROVEMENTS BY RAILROAD COMPANY. In the case of a railroad where old rails are replaced with new and heavier rails, wooden bridges and culverts with concrete and steel bridges and culverts, the cost of renewals with like kind and quality is allowable, but excess cost is not allowable as a deduction.[12]

OFFICE FURNITURE AND EQUIPMENT. An ordinary amount expended for renewal of office furniture and equipment, and charged to expense, has been held not to be invested in assets, but to be a proper expense of maintenance of the business of an insurance company, which it was entitled to deduct in ascertaining its taxable net income under the 1909 Law. The company had expended in one year $1,213 for ordinary renewals of office furniture, in another year $1,379, and an additional sum of $1,808 for ordinary renewals of attendants' uniforms, door mats, window shades, awning, small hardware, oils and other articles of like character and also the sum of $2,244 for ordinary renewals of

9 Reg. 45, Art. 102.

10 Reg. 33, Art. 131; Reg. 45, Art. 103. Maintenance means the upkeep or preserving of the condition of the property to be operated and does not mean additions to the equipment, property or improvements of former condition of the property. Grand Rapids, etc., Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

11 Reg. 45, Art. 103; letter from Treasury Department dated September 19, 1916.

12 Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

office equipment, consisting of lamps, alterations of fixtures, shades, meters, fans, plugs, wirings, etc., and these expenditures were no greater than the average of similar expenditures for other years and did not exceed 5% of the cost of all the plaintiff's existing furniture and equipment similar to the articles detailed, and none of the items was considered in the corporation's books or statement as assets because of their rapid depreciation. The articles mentioned were of a perishable and transient nature, and properly charged to expense of maintenance, since they apparently did no more than maintain in proper condition and repair the ordinary equipment of office furniture and supplies.[13]

Expenditures for Alterations. In the case of a company which expended approximately $5,000 for alterations in its home office, apparently solely with a view of facilitating the carrying on of its business, it was held under the 1909 Law that such amount was properly deducted as an expense. The Court said in part: "It should be remembered, also, that in these days of up-to-date business method requirements it often becomes necessary for business concerns to change the lay-out and appointments of the places wherein they carry on business, with a view to economy in space, a saving of unnecessary labor, and the bettering of working conditions of employees, to the end that a net saving of running expenses will result. In view of the consistent expansion of the plaintiff's business, which the evidence shows, it would seem that the amount expended for the changes made in the office ought not under the circumstances, to be considered unreasonable or unusual, and that, therefore, the amount claimed might well have been allowed as an item of deduction. It seems to the court that business concerns, in matters of this kind, should be allowed a reasonable discretion, and the law so enforced as to help rather than to hinder them in making reasonable progress in the development of their business, for it must appear to anyone giving the matter a moment's consideration that the more successful a business the larger the results, even from the standpoint of taxes accruing to the government."[14]

Repairs and Improvements Made by a Tenant. Where a lease requires the tenant to make all necessary repairs or improve-

13 Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.
14 Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206.

ments, which repairs or improvements revert to the landlord at the expiration of the lease, the tenant may charge the cost of all such repairs and improvements as an expense of doing business. If the improvements are somewhat permanent in character, the expense should not be all deducted in one year, but should be pro-rated over the number of years constituting the term of the lease, and the amount deductible in each year would be the aliquot part of such cost.[15] Taxes or other expenses paid by the tenant for the landlord should be deducted by the tenant as expense.

COST OF BUILDINGS ERECTED BY TENANT UNDER TERMS OF LEASE. Where, under the terms of a lease, a tenant agrees to erect a building, or to expend during the rental period a fixed sum in making improvements upon the freehold, the building or permanent improvements become a part of the realty, unless otherwise agreed upon between the contracting parties. As the use of the building or permanent improvement by the tenant, during the term of the lease, is a part of the consideration of the contract, the cost of such buildings or improvements may be prorated by the tenant over the leased term and deducted, at an annual rate, as a part of the necessary expenses actually paid in carrying on any business or trade. The tenant may also deduct the cost of incidental repairs and maintenance to such buildings and improvements, but no depreciation may be claimed with respect to such buildings and improvements.[16] If the building is erected, or permanent improvements are made after the lease is partially expired, the cost thereof may be divided by the number of years the lease then has to run, and if the life of the lease is longer than the estimated life of the building or improvements, the cost may be divided by the number of years such building or improvements are expected to last, instead of the number of years constituting the life of the lease.[17]

Buildings Used for Rental Purposes. A landlord may claim as an expense any amounts expended for maintenance of the property or its use for rental purposes, including amounts paid for repairs, insurance, fuel, light and water, and janitor and ele-

15 T. D. 2137.

16 Reg. 45, Art. 109; T. D. 2442; Reg. 33, Art. 115.

17 Reg. 45, Art. 109; Letter from Treasury Department dated February 27, 1917; I. T. S. 1918, ¶ 1506.

vator service, if any.[18] Where the landlord occupies a part of the building as his own dwelling he should not deduct such proportion of the expenses of operating the building as inure to his personal benefit, as that part constitutes personal or living expenses which are not deductible. Thus, if a landlord lives in one-half of the building, one-half of the expenses are not an allowable deduction in his return.

Payment in Lieu of Rental. Where a leasehold is purchased and paid for in one sum at the beginning of the lease the amount so paid may be divided by the number of years constituting the life of the lease and a deduction made annually of a proportionate amount, such item to be claimed as a payment made in lieu of rental.[19]

Insurance on Property. Insurance premiums paid on property used for business purposes, or rented or leased to secure an income, are an allowable deduction.[20]

Fidelity Insurance. Where an employee is required to furnish a bond and pay the premium thereon, as a necessary incident to his employment, the amount so paid may be deducted by him as an expense.[21] If the employer pays the premium it may be included in his business expense.

Insurance Reserves. Funds set aside by a corporation for insuring its own property are not a proper deduction as a business expense, but any loss actually sustained may be deducted, although actually paid out of a fund so set aside.[22]

Life Insurance. Premiums paid on any life insurance policy covering the life of any officer or employee or any person financially interested in any trade or business carried on by a taxpayer directly or indirectly a beneficiary under such policy may not be deducted as a business expense.[23]

18 Letter from the Treasury Department dated February 26, 1915; I. T. S. 1919, ¶ 920.

19 Reg. 45, Art. 109; Letter from Treasury Department dated February 27, 1917; I. T. S. 1918, ¶ 1506.

20 Reg. 45, Art. 101; T. D. 2090.

21 T. D. 2090.

22 Reg. 33, Art. 122.

23 Revenue Act of 1918, §§ 215, 235. See Chapter 21. It was held by the Treasury Department that the corresponding provision of the 1916 Law, as amended (Revenue Act of 1916, § 32, added by Revenue Act of 1917), applied to all forms of life insurance, the premiums upon which the individual, partner-

Subtraction for Redemption of Trading Stamps. Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer should file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (*a*) the total issue of stamps during each year, (*b*) the total stamps redeemed in each year, and (*c*) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement should also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required.[24]

Propaganda Expenses. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income.[25]

Commissions. Commissions paid to a real estate agent for collecting rents and managing property are allowed as a business expense to the owner. Commissions paid to salesmen as a part of

ship or corporation might pay, whoever might be the beneficiaries. (Reg. 33 Rev., Art. 236.) Prior to the passage of this provision it was held by the Treasury Department that such premiums were deductible (T. D. 2090). This ruling was subsequently reversed and it was held thereafter that premiums were not deductible (T. D. 2519, dated August 30, 1917). It seems, from the language of this latter Treasury Decision, that it was not intended to have a retroactive effect for years prior to 1917.

[24] Reg. 45, Art. 87; Reg. 33 Rev., Art. 141.

[25] Reg. 45, Art. 562; T. D. 2137.

the expense of conducting business are also allowed as a deduction.[26] Commissions paid in purchasing and selling securities are a part of the cost or selling price of the securities and are not otherwise deductible.[27]

Entertainment Money. So-called spending or treating money actually advanced by business enterprises to their traveling salesmen, as a part of the selling expense of their product, is a proper deduction. There must, however, be some showing that all of the allowance claimed as a deduction has been actually expended for the purpose for which the allowance is made, namely, the selling of the product in question.[28]

Salaries and Compensation for Personal Services. The 1916 Law did not expressly mention "salaries" in the provisions allowing the deduction of business expenses.[29] The 1918 Law expressly authorizes the deduction by employers of "a reasonable allowance for salaries or other compensation for personal services actually rendered."[30] The rulings hold the test of deductibility to be whether in fact payments of salaries are reasonable and are purely for services or include "*some other element.*" In the case of any compensation, however determined, which exceeds amounts ordinarily paid for like services in like enterprises under like circumstances, the burden is upon the taxpayer to show that the amount paid is solely the purchase price of services. The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the enterprise and the individual made before the services are rendered, not influenced by any consideration on the part of the employer

26 T. D. 2090.

27 Reg. 45, Art. 293; Reg. 33 Rev., Art. 8.

28 T. D. 2090.

29 Revenue Act of 1916, § 5 (a) and § 12 (a).

30 Revenue Act of 1918, §§ 214 (a) and 234 (a). These provisions seem to authorize the Commissioner to disallow such part of any salary payments as appear unreasonable in view of the services rendered, notwithstanding that the salary may actually have been paid under a valid contract.

other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid. In any event the allowance for compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[31]

SALARIES CONSTITUTING A DISTRIBUTION OF DIVIDENDS. Any amount paid in the form of a salary, but not in fact as the purchase price of services is not deductible. In the case of corporations, a salary paid to an officer or employee who is not a stockholder is a proper deduction if it fulfills the requirements stated in the preceding paragraph. Where the officer or employee is also a stockholder, the salary deduction is subjected to closer scrutiny. An ostensible salary may be a distribution of a dividend on stock, especially in the case of a corporation having a few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, the presumption will be that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock.[32] In the case of excessive

31 T. D. 2696, Reg. 45, Arts. 105, 106. It was held under the 1916 Law that reasonableness was ordinarily the controlling test of the deductibility of salaries determined *after* services had been rendered. In certain instances apparently of this sort it was permitted to be shown that the compensation was fixed according to a custom or practice having virtually the force of a contract. Where this was not true and it was for the management to fix a fair compensation it was assumed that true compensation was only such amount as would ordinarily be paid in like circumstances by similar enterprises; in other words, that the fair criterion was what the recipient could get by rendering the same services to another employer. (T. D. 2696.)

32 Reg. 45, Art. 105. It was first held that the following rules should be observed in connection with such payments: (a) the services must be actually performed, (b) the amount must be no more than a fair and reasonable compensation for services rendered, and (c) the compensation should not depend upon the interest of the officer or employee in the corporation as a

payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients.[33]

SALARIES CONSTITUTING A WASTE OF ASSETS. An ostensible salary paid by a corporation may be in part a waste or appropriation of assets of the corporation, especially where salaried employees are in control of the corporation through holding, directly or indirectly, a majority of its stock. In the case of a large corporation with many stockholders owning a substantial minority of its stock the tendency of officers unduly to inflate their salaries must be taken into account. In such cases payments representing a waste or appropriation of assets of the corporation by officers who control it and fix their compensation in violation of the rights of the corporation are held not to be deductible to the amount of their excess over a reasonable compensation. While disallowed as a deduction to the corporation such payments are required to be treated as compensation of the individuals, subject to the normal tax, compensation illegally secured being none the less subject to tax in all respects.[34]

SALARIES CONSTITUTING PART PAYMENT FOR PROPERTY. An ostensible salary may be in part payment for property. This may

stockholder or vary from year to year with the earnings of the corporation. (T. D. 2152; letter from Treasury Department dated February 2, 1915; I. T. S. 1918, ¶¶ 1389 and 1811.) Under the 1909 Law it was held that in addition the salary paid to an officer who was a stockholder must be authorized by the board and made a matter of record on the minute book of the corporation, in order to be an allowable deduction. (T. D. 1742.) Where a company was composed of two stockholders who divided the net profits between them, calling it compensation, it has been held by the courts that the money paid out was equivalent to a dividend. (Jacobs and Davies, Inc., v. Anderson, 228 Fed. 505; T. D. 2262.)

[33] Reg. 45, Art. 106; T. D. 2696. See also Reg. 33, Art. 119. It is conceivable, of course, that an individual may render services of great value to a corporation of which he is the chief stockholder and it seems reasonable that he should be entitled to compensation for services he actually performs in addition to his dividends as a stockholder since as a stockholder he is under no duty to devote any part of his time to the business of the corporation.

[34] Reg. 45, Arts. 105, 106. Under the 1916 Law if a compensation contract with the majority stockholder or stockholders was approved by all the stockholders, as well as by the directors, it might however be dealt with like any other contract. (T. D. 2696.)

occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business. The amount of the excess should be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price.[35]

Excessive Payments by Individuals or Partnerships. In the case of excessive payments by individuals or partnerships, the amounts disallowed should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[36]

Salaries Paid to Enlisted Men. An individual, partnership or corporation continuing to pay an officer or employee his salary or compensation, or part thereof, while he serves in the United States Army or Navy or while he has undertaken services for the Government at Washington or elsewhere at reduced or nominal compensation, is permitted to deduct the amount as an expense, on the theory that the business purpose of the continuance of such compensation is to preserve the organization and secure the return after the war of such officers or employees.[37]

Allowances to Minor Children. The father is legally entitled to the services of his minor children. Allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions.[38]

Bonuses and Profit Sharing Payments. The rules and regulations[39] in regard to the deductibility of special payments made as extra compensation to officers or employees of an enterprise,[40] do

35 Reg. 45, Arts. 105, 106.

36 Reg. 45, Art. 106.

37 Reg. 45, Art. 108; T. D. 2660; letter from Treasury Department dated October 4, 1916; I. T. S. 1918, ¶ 1391.

38 Reg. 45, Art. 291. See Chapter 21.

39 Reg. 45, Art. 107; T. D. 2696; T. D. 2616; T. D. 2152; T. D. 2090; Reg. 33 Rev., Arts. 8 and 138; letter from Treasury Department dated June 25, 1914; I. T. S. 1918, ¶ 1398; Mimeograph letter to Collectors No. 1314, I. T. S. 1918, ¶ 1401; letter from Treasury Department dated November 12, 1917; I. T. S. 1918, ¶ 1407.

40 The later rulings treat the question irrespective of the status of the payor of the bonus, establishing the same rule, so far as deductibility is concerned,

not permit of a ready determination of every question,[41] but indicate an increasing liberality on the part of the Treasury Department toward the allowance of such payments as deductions. All such payments to officers or employees having any considerable interest in the profits of the enterprise through stock ownership or otherwise are subject to careful analysis in the same manner as salaries. The scope of this scrutiny has been treated in the foregoing paragraphs. As previously stated, while any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Just as in the case of salaries, the test is whether the payments are made in good faith and are in fact purely for services or include "some other element." Generally speaking, if contingent compensation is paid pursuant to a friendly bargain between the enterprise and the individual, made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, the contingent compensation should be allowed as a deduction; even though in the final working out of the contract it may prove to be greater than the amount which would ordinarily be paid. Reasonableness is ordinarily the controlling test of the deductibility in the case of bonuses and special compensation for services, as in the case of salaries. Summarizing the latest rulings[42] the following rules may be stated as a basis for the determination of the question whether special payments made as extra compensation to officers and employees of an enterprise are deductible under the heading of business expenses: (a) the fundamental test is whether or not such payments are made as compensation for services rendered; (b) if payments of compensation for services rendered are made in pursuance of a contract express or implied (which need not be in writing)[43] or a long-time practice (practically an implied con-

in the case of individuals, partnerships and corporations. The term "enterprise" is used in the text to include all these three forms of business activity.

41 They are said "to indicate a basis of solution" when applied "in the light of full knowledge of the facts in the particular case." (T. D. 2696.)

42 Reg. 45, Art. 107; T. D. 2696.

43 A written contract is, of course, better evidence in case any question arises.

tract), regularly employed, of paying to employees certain sums in addition to their stipulated salaries, constituting a condition, if not a contract, whereby the employees may reasonably expect for greater or better service rendered, additional pay, they are deductible; (c) if payments are made as compensation for services rendered, but not in pursuance of a contract expressed or implied or a long-time practice as above stated, the total amount of salary and extra compensation may not exceed a reasonable compensation for the services rendered. The early condition that payments of bonuses or extra compensation could not be dependent upon the earnings of the paying corporation no longer obtains except in so far as it may throw light upon the question of whether or not the payments in question are made as compensation for services rendered.[44]

GIFTS, GRATUITIES OR DONATIONS TO EMPLOYEES. Gifts or gratuities made by an enterprise to its employees are not proper deductions under the heading of expense. Even where such payments are called extra compensation, if they are in fact gratuitous or voluntary payments for which no services are rendered, their character as gifts is not changed. The custom of paying bonuses or Christmas gifts to employees, even though it has been the practice of the enterprise for a long time to make such gifts, does not render the amount so paid a proper deduction as expense if the gift is purely voluntary and gratuitous.[45] On the other hand, gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith

[44] The early rulings held in effect that payments made by a corporation as extra compensation to officers and employees might be deducted: (a) if it was clearly shown that they were made as compensation for services rendered; (b) if they were paid in pursuance of a contract express or implied; (1) the contract need not have been in writing, (2) a long time practice (practically an implied contract), regularly employed, of paying to employees certain sums in addition to their stipulated salaries constituted a condition if not a contract, whereby the employees might reasonably expect, for greater or better services rendered, additional pay and was equivalent to a contract within this heading; (c) if the total amount of salary and extra compensation was not greater than a reasonable compensation for the services rendered, (d) if they were not conditional upon the earnings of the corporation but were conditional or dependent upon the services rendered. (See note 39.) These tests were later modified, as indicated in the text above.

[45] Reg. 45, Art. 107. See T. D. 2090; T. D. 2152; Mimeograph letter to Collectors, No. 1314; I. T. S. 1918, ¶ 1407.

and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income.[46]

Pensions. Under the 1916 Law the deduction of amounts paid as pensions was allowed or disallowed upon the basis of the general provisions[47] of that law permitting the deduction of all the necessary expenses of individuals in carrying on any business or trade and the ordinary and necessary expenses of corporations paid in the management and operation of their business and properties. The Revenue Act of 1918 expressly provides[48] that these expenses include "a reasonable allowance for salaries and other compensation for personal services actually rendered." But the intent is probably not to exclude pensions by reason of services which have been rendered. It has been ruled that amounts paid for pensions to retired employees or to their families or others dependent upon them, or on account of injuries received by employees, and lump sum amounts paid as compensation for injuries, are a proper deduction as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. No deduction may be made for contributions to a pension fund held by the corporation, the amount deductible in such case being the amount actually paid to the employee. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of the services rendered by the individual, such payments may be deducted.[49]

Donations. Donations by business concerns may or may not be held to be proper deductions as expense. There must be a consideration in some form to take the donation out of the class of gratuities. When a donation legitimately represents a considera-

46 Reg. 45, Art. 107.

47 Revenue Act of 1916, §§ 5a and 12a.

48 Revenue Act of 1918, §§ 214 (a) 1 and 234 (a) 1.

49 Reg. 45, Art. 108. This reverses the earlier rulings of the Treasury Department regarding salaries paid to the widow or heirs of the employee after his death. (Reg. 33 Rev., Art. 136; T. D. 2090.)

tion for a benefit flowing, directly or indirectly, to the donor, as an incident of its business, it is an allowable deduction. It has been held that a corporation engaged in the agricultural business cannot be allowed to make deductions on account of donations to fairs, churches, and associations; such donations, although made for the purpose of obtaining and preserving the good will of the farmers, being mere gratuities. Where a street railway company donates a sum of money to an organization intending to hold a convention in the city in which the company operates, with the expectation that the holding of such convention will augment its income because a greater number of people will use its street cars, the donation has been held to be deductible. A donation to a hospital, under agreement that employees of the donor are to have a ward for their use in case of accident or illness is a proper deduction. Donations made for purposes connected with the operation of the business, when limited to charitable institutions, hospitals or educational institutions, conducted for the benefit of employees or their dependents, are within this class, but such donations should be reduced by any amount repaid to the corporation by the employees. Red Cross donations are not within the class. Expenses incurred in advertising and promoting the sale of liberty bonds and war savings stamps over the corporation's name are deductible.[50]

Sale and Retirement of Corporate Bonds. If bonds are issued by a corporation at their face value, and thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If the bonds are issued at a premium and the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. If the bonds were issued at a discount and they are subse-

[50] Reg. 45, Art. 562; T. D. 2847; Reg. 33 Rev., Art. 134; letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437; telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436. As to Red Cross donations, see T. D. 2847.

quently purchased and retired at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year.[51] It was held under the 1916 Law that in cases wherein a corporation sells its bonds at a discount and pays a commission for selling, the amount of such discount and commission, together with other expenses incidental to issuing the bonds, constitutes a loss, the aggregate amount of which loss should for the purpose of an income tax return, be prorated over the life of the bonds sold, the amount thus apportioned to each year being deductible from the gross income of each such year until the bonds shall have been redeemed.[52] Under the later rulings it would seem that such amounts, while deductible, should be treated as expense.

Payments from Earnings of Public Utility Paid to State. In the case of a public utility acquired, constructed, operated or maintained by a taxpayer under contract with any State, Territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the State, Territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business.[53]

Expense in Oil and Gas Industry. For purposes of the oil and gas industry it is ruled that expense includes all amounts paid out (exclusive of amounts paid for physical property and development charged to Capital Sum) incident to the development and operation of producing properties and the preparation of their product for market, such as costs of pumping, cleaning, reshooting (including cost of torpedoes), gauging, storing, treating, reducing, repairs and maintenance, transporting, refining, conserving, marketing, overhead expense, insurance, etc. The cost of repairs and replacements made necessary through

51 Reg. 45, Art. 544. Such amounts were deductible as a loss prior to this later ruling. (Letter from Treasury Department dated March 23, 1915; I. T. S. 1918, ¶ 1437.) See p. 326.

52 Reg. 33 Rev., Art. 150.

53 Revenue Act of 1918, § 213 (b) 7; Reg. 45, Art. 84; T. D. 2090; see Revenue Act of 1916, § 11 (b).

deterioration of equipment may be charged off as expense, but if this is done the amount allowed as a depreciation deduction will be reduced. In all cases items of expense must be charged off as such for the year incurred and can neither be deducted from the income of subsequent years as expense nor added to Capital Sum.[54]

[54] Manual for the Oil and Gas Industry, p. 15. See Chapter 29.

CHAPTER 23

DEDUCTION OF INTEREST

The Revenue Act of 1918 provides that citizens and residents and domestic corporations may deduct all interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation as income to the taxpayer. Non-resident aliens and foreign corporations may deduct that proportion of such interest which the amount of his or its gross income from sources within the United States bears to the amount of his or its gross income from all sources within and without the United States.[1] But this deduction is allowed to a non-resident alien only if he files a true and accurate return of his total income from all sources, corporate or otherwise, in the manner prescribed[2] by the law. In all cases, interest upon indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from the income tax to the taxpayer, may not be deducted. Thus, a citizen or resident may, with the one exception above stated, deduct all interest paid or accrued within the taxable year on his indebtedness. This includes not only indebtedness incurred for business purposes, but indebtedness incurred for any purpose, such as for the purpose of buying dwelling houses or any articles or things of personal use.

Interest on Capital. Interest calculated as being a charge against income on account of capital or surplus invested in the business, but which does not represent a payment on an interest-bearing obligation, is not an allowable deduction from gross in-

[1] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2; Reg. 45, Art. 121. The limitations imposed by the 1916 law upon the amount of interest which might be deducted by corporations is discussed in the Appendix.

[2] Revenue Act of 1918, § 217.

come; that is to say, the interest which the money might earn if otherwise invested is not a deductible charge against income.[3]

Indebtedness Incurred or Continued to Purchase or Carry Tax-Exempt Securities. The Revenue Act of 1918 does not permit the deduction of interest paid or accrued on "indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer."[4] State and municipal bonds are obligations or securities falling within this class, as well as National bonds issued prior to September 1, 1917. Interest on indebtedness incurred for the purchase of Liberty bonds of the second issue (the interest on which is not entirely exempt from the surtax) was held deductible regardless of the limitation contained in the 1917 Law.[5] By the parenthetical clause of the 1918 provision taking obligations of the United States issued after September 24, 1917, out of the exception to the deductibility of interest, the Revenue Act of 1918 makes it clear that interest on indebtedness incurred or continued to purchase or carry Liberty bonds of the second and subsequent loans will be allowed as a deduction.[6] The extension of the exception to the deductibility

[3] Reg. 45, Art. 122.

[4] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2. Prior to its amendment by the Revenue Act of 1917, it was held under the 1916 Law that interest paid on indebtedness might be deducted, whether or not the indebtedness was incurred for the purchase of bonds, the interest upon which was exempt from taxation. This ruling in effect permitted a double deduction, that is, the interest on the money so borrowed could be deducted and the income derived from the money so borrowed and invested could also be deducted. The 1917 Law did not permit the deduction of interest paid on "indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title." (Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.)

[5] Reg. 45, Art. 121; T. D. 2511.

[6] Reg. 45, Art. 121. The provision of the statute permitting the deduction of *all* interest paid or accrued within the taxable year is the subject of some criticism on the ground that it permits a reduction of the income tax by the purchase of non-taxable securities with borrowed money. The remedy proposed is that the interest deduction be limited to an amount bearing the same proportion to the total interest paid upon indebtedness which the taxpayer's income derived from taxable sources bears to his income from all sources. The provision of the 1918 Law as it now stands permits the deduction of *interest paid or accrued on indebtedness incurred or continued to purchase or carry*

of interest to indebtedness "continued" as well as incurred, and incurred or continued to "carry" as well as to purchase tax-exempt securities should be noted.

Interest Paid or Accrued Within the Year. The 1909 Law provided for the deduction of "interest actually paid within the year" and it was contended by the Treasury Department that this provision required that the interest should be both accrued and paid within the same year. It was held, however, that interest actually paid within the year although previously accruing should be permitted as a deduction.[7] The 1913 Law provided for the deduction of interest paid within the year by individuals, and "interest accrued and paid within the year" by corporations. In a ruling under that law it was held that in the case of corporations the deduction should be limited to interest which had both accrued and been paid within the same year.[8] The 1916 Law permitted the deduction of interest "paid within the year."[9] The Revenue Act of 1918 permits the deduction of interest "paid *or* accrued within the taxable year."[10] It does not seem essential

obligations of the United States issued after September 24, 1917. The parenthetical exception to the general restriction upon the deduction of interest was designed to stimulate the sale of Liberty Bonds. It will be remembered that the Victory or Fifth Liberty Loan consisted of two kinds of notes; that is, (1) 4-¾% three/four year convertible gold notes exempt from state and local taxes except estate and inheritance taxes and from *normal* Federal taxes, (2) 3-¾% three/four year convertible gold notes exempt from *all* Federal, state and local taxes except estate and inheritance taxes. It could hardly have been contemplated at the time §§ 214 (a) 2 and 234 (a) 2 (a) were drawn that the Victory Loan would include any wholly exempt notes or bonds. This section of the law should be amended to guard against the evasion of the surtax by the heavy purchase of the above 3-¾% notes with borrowed money.

7 Anderson v. 42 Broadway Co., 213 Fed. 777. The Supreme Court in reversing the lower court (239 U. S. 69) did not pass on the question of deducting interest accrued in one year and paid in another.

8 T. D. 1960.

9 Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.

10 Revenue Act of 1918, §§ 214 (a), 2, 234 (a) 2. The term "paid or accrued" is to be construed according to the method of accounting upon the basis of which the net income of the taxpayer is computed. (Revenue Act of 1918, § 200.) Under the 1916 Law, corporations keeping books of account on an accrual basis were permitted to deduct interest for the year whether paid or not, when such interest was shown as a charge against accrued income upon the books of account (T. D. 2625).

under these provisions that interest should have accrued or become payable in the year in which it is paid in the case of taxpayers reporting on a basis of cash receipts and disbursements.

Sale and Retirement of Corporate Bonds. If bonds are issued by a corporation at a discount, the net amount of such discount is deductible as interest and should be prorated or amortized over the life of the bonds.[11] The intention of this ruling is to allow corporations selling their own bonds at a discount to pro-rate the discount over the life of the bonds and to deduct from gross income each year an aliquot part of the discount, determined in accordance with the number of years which the bonds have to run from the date of issue. If, however, the bonds were issued prior to the incidence of the tax and, at that time, the entire amount of the discount was charged to profit and loss, the issuing corporation may not claim a *pro rata* allowance for such discount for the years subsequent to the incidence of the tax.[12] Charging off the discount prior to the incidence of the tax constitutes a closed transaction and such transaction cannot be reopened for the purpose of reducing the taxable income of the corporation.[13] Thus where a railroad company sold bonds and equipment notes at a discount in 1906 and its books show that the loss was entirely charged off under the profit and loss account for 1906, and the company in making returns for the years 1911 and 1912 failed to deduct the proportionate amount of discount sustained, it has no right to amend its returns and claim a refund of such amount.[14] The court has held that if a loss sustained by a corporation selling its own bonds at a discount is an expense, it will not be paid until the maturity of the bonds and should, therefore, be prorated over the life of the bonds, and not deducted in full in the year in which the bonds were issued.[15] It has been held that where a corporation sold bonds at a discount during 1906, 1907, and 1908 no deduction from gross income for the years 1909, 1910, and 1911 of sums set aside by the corporation to pay

11 Reg. 45, Arts. 544, 563. Formerly, the amount of such discount was deducted and prorated over the life of the bonds, but was treated as a loss instead of as interest. (Reg. 33 Rev., Art. 150.)

12 T. D. 2161.

13 T. D. 2137.

14 Chicago and Alton R. R. Co. v. U. S.; T. D. 2631.

15 Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

such discount at the maturity of the bonds could be permitted under the language of the 1909 Law which authorized the deduction only of "interest actually paid within the year on its bonded or other indebtedness." [16]

Maryland and Pennsylvania Ground Rent. Payments made for Maryland or Pennsylvania ground rents are not deductible as interest.[17]

Interest on Real Estate Mortgage. Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.[18]

16 Southern Pacific R. R. Co. v. Muenter, U. S. C. C. A., Ninth Circuit, decided October 6, 1919; I. T. S. 1919, ¶ 3639; T. D. 2944.

17 Reg. 45, Art. 121.

18 Reg. 45, Art. 121.

deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted.[8]

Capital Stock Tax. For the purpose of computing other income subject to income and excess-profits taxes, the capital stock tax may be deducted from the gross income for the year for which such taxes accrue, if accounts of the corporate taxpayers are kept on the accrual basis, or may be deducted from gross income for the year in which paid, if accounts are kept on the disbursement basis.[9]

Depositors' Guaranty Fund. Banking corporations, which pursuant to the laws of the States in which they are doing business are required to set apart, keep and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.[10]

Automobile License Fees. It has been ruled that automobile license fees are ordinarily taxes and therefore deductible.[11]

Securities Taxes. Amounts paid to States under secured debts laws in order to render securities tax-exempt are deductible.[12]

[8] Reg. 45, Art. 132.

[9] Letter from Treasury Department dated June 7, 1919; I. T. S. 1919, ¶ 3428.

[10] Reg. 45, Art. 567; T. D. 2152.

[11] Reg. 45, Art. 131.

[12] Reg. 45, Art. 131.

Taxes Paid by a Tenant. Where a tenant pays the taxes on property leased by him, he may consider the amount so paid as an additional payment of rent and may deduct it as an expense of carrying on his business.[13] To the landlord the amount is equivalent to an additional payment of rent and must be reported as such, but he may also deduct the amount, as, to him, it is a tax paid during the year by the tenant as his agent. The transaction is tantamount to a payment of the sum by the tenant to the landlord and a repayment by the landlord to the tenant, as his agent, for the purpose of satisfying the tax.[14]

Taxes Not Deductible. The Revenue Act of 1918 expressly provides that no taxpayer shall deduct (a) income, war-profits and excess-profits taxes imposed by the authority of the United States, (b) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (c) taxes paid by a corporation pursuant to a so-called "tax-free" covenant contained in its bonds, mortgages, deeds of trust, or other similar obligations; and that non-resident aliens and foreign corporations may not deduct (a) income, war-profits and excess-profits taxes imposed by the authority of any foreign country, and (b) taxes assessed against local benefits of a kind tending to increase the value of the property assessed imposed by the authority of any foreign government.[15] Although income, war-profits and excess-profits taxes imposed by the authority of any possession of the United States, or any foreign country (in the case of citizens or residents or domestic corporations) are not allowed as a deduction, they are allowed as a credit against tax.[16] The 10% tax imposed by the Revenue Act of 1916 as amended, on the undistributed net income of corporations is considered an income tax and is therefore not deductible.[17] War-profits and excess-profits taxes imposed by the 1918 Law may be deducted from the net income of domestic or foreign corporations in computing the income tax for the same taxable year.[18] In addition to the above it

13 T. D. 2090.

14 Reg. 45, Art. 109.

15 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

16 Revenue Act of 1918, §§ 222, 238.

17 Letter from Treasury Department dated April 1, 1919; I. T. S. 1919, ¶ 3285.

18 Prior to its amendment by the Revenue Act of 1917 it was held under

deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted.[8]

Capital Stock Tax. For the purpose of computing other income subject to income and excess-profits taxes, the capital stock tax may be deducted from the gross income for the year for which such taxes accrue, if accounts of the corporate taxpayers are kept on the accrual basis, or may be deducted from gross income for the year in which paid, if accounts are kept on the disbursement basis.[9]

Depositors' Guaranty Fund. Banking corporations, which pursuant to the laws of the States in which they are doing business are required to set apart, keep and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.[10]

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[8] Reg. 45, Art. 132.
[9] Letter from Treasury Department dated June 7, 1919; I. T. S. 1919, ¶ 3428.
[10] Reg. 45, Art. 567; T. D. 2152.
[11] Reg. 45, Art. 131.
[12] Reg. 45, Art. 131.

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13 T. D. 2090.

14 Reg. 45, Art. 109.

15 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

16 Revenue Act of 1918, §§ 222, 238.

17 Letter from Treasury Department dated April 1, 1919; I. T. S. 1919, ¶ 3285.

18 Prior to its amendment by the Revenue Act of 1917 it was held under

has recently been held that inheritance taxes are not deductible.[19] Taxes paid by a corporation for its stockholders have been held by the courts not to be deductible. Postage is not a tax and is therefore not deductible.[20]

TAXES ASSESSED AGAINST LOCAL BENEFITS. The taxes contemplated by the law as deductible are those which are paid to defray the expense of running the government. Where the taxpayer pays an assessment for something which will directly benefit him or his property it is not considered to be a tax in the true sense but rather in the nature of an investment in property. The Revenue Act of 1918 expressly provides that taxes assessed against local benefits "of a kind tending to increase the value of the property assessed" shall not be deductible.[21] It has been ruled that so-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to the property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to

the 1916 Law that the income tax paid on income of one year, whether paid by the taxpayer or withheld at the source, was property deductible from the net income of the following year. (T. D. 2135.) The 1917 amendment provided that income and excess-profits taxes paid by the taxpayer should not be allowed as a deduction (Revenue Act of 1916, §§ 5, 6, 12 (a) and 12 (b) as amended by the Revenue Act of 1917), but in assessing the income tax the net income embraced in a return made under the 1917 Law was credited by the Commissioner with the amount of any excess-profits taxes imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer, and in the case of a member of a partnership, with his proportionate share of such excess-profits taxes imposed upon the partnership. (Revenue Act of 1916, § 29, added by Revenue Act of 1917.)

19 Reg. 45, Art. 134. See p. 367.

20 Reg. 45, Art. 131.

21 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

levees, are limited to property benefited, and when it is clear that the assessments are so limited, the amounts paid thereunder are not deductible as taxes. When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense incurred in business, if the payment of such assessments is necessary to the conduct of his business. Where the assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible. Where assessments are made for the purpose of both construction and maintenance or repairs, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation can not be made, none of the amounts so paid is deductible.[22]

TAXES PAID UNDER "TAX-FREE" COVENANTS. Where a corporation pays taxes for its bondholders under stipulations in bonds agreeing to pay the interest in full regardless of any tax which it may be required to withhold or deduct, the amount of taxes so paid on behalf of such bondholders is not a proper deduction by the corporation.[23] The bondholder may, however, treat the amount so paid for him as his tax and deduct the same, if it is a tax levied by a State; if levied by the Federal government he cannot deduct the amount as the law expressly prohibits deduction of the Federal income tax. The amount of income tax paid for a bondholder by an obligor pursuant to a tax-free covenant in its bonds is in the nature of additional interest paid the bondholder and must be included in his gross income.[24]

STATE INHERITANCE TAXES. State inheritance taxes paid by the executor or administrator of an estate of a deceased person, which are provided by law to be deducted from the respective legacies or distributive shares, are not allowable deductions in computing the net income of such estate subject to tax, even though the will contain a direction to pay inheritance taxes out of the residue. An inheritance tax is upon the transfer of the property and not upon the estate of the decedent or upon the

22 Reg. 45, Art. 133, as amended by T. D. 2937. See also T. D. 2090; Reg. 33, Art. 153.

23 Revenue Act of 1918, § 234 (a) 3. See T. D. 1948. The rulings on this point are contained in Chapter 20.

24 Reg. 45, Art. 31.

executor or administrator, although the latter is required to pay it. In general, taxes paid or accrued within the year imposed by the authority of any State, or otherwise, are limited to those imposed upon the taxpayer and do not include taxes paid by him on behalf of another, even though he is required by law to make such payment. Since, moreover, state inheritance taxes are imposed upon the transfer before the property reaches the legatee or the distributee, and merely diminish the capital share of the estate received by him, such taxes are not imposed upon the legatee or distributee and are not an allowable deduction from his gross income. Similarly, Federal estate taxes are not deductible.[25]

TAXES PAID BY CORPORATION FOR STOCKHOLDERS. Under the statutes of many of the States taxes are assessed against the stockholders of banks, the bank being required to pay the tax on behalf of its stockholders. Banks paying taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such banks can not deduct the amount of taxes so paid. The shares of stock being the property of the stockholders, to the extent that the taxes assessed on the value of the shares of stock are property taxes the holders are primarily liable for their payment. As Federal statutes prohibit States from imposing any tax upon national banks except upon the value of their real estate, in cases where States levy a tax on the stock of such banks and make it the duty of the banks to pay such tax for the stockholders it is clear that such payments are not deductible from the gross income of such banks. This rule applies also in the case of corporations other than banks, upon the value of whose stock taxes are assessed to the stockholders.[26] As a general rule the

[25] Reg. 45, Art. 134; letter from Treasury Department dated February 10, 1916; I. T. S. 1918, ¶¶ 486, 796 and 1669; T. D. 2933; Prentiss v. Eisner, U. S. Dist. Court, So. Dist. of N. Y.; I. T. S. 1919, ¶ 3595, decided under the 1913 Law. In this case, speaking of the New York Inheritance Tax, the Court said: "The condition of the devolution of the property is the receipt of the transfer tax by the state. * * * I * * * am convinced that the tax cannot properly be regarded as an imposition upon either the property or the right to receive a gross amount of the property of a decedent represented by a legacy, devise or distributive share, but that the property and the right to receive it passed, reduced by the amount of the tax measured by a percentage of the value of the gross share." (T. D. 2933.)

[26] Reg. 45, Art. 566. In such cases it was held, under the 1909 Law, that the bank was not entitled to deduct the amount of taxes so paid as the tax

amounts of taxes so paid by a corporation for its stockholders are not collected from the stockholders, the corporation charging the taxes as an item of expense. Such taxes, however, should be reported by the stockholders respectively as taxes paid by them, according to their proportionate interests in the corporation.[27] The amount of the taxes so paid should also be treated as additional dividends from the net earnings of the corporation.[28] Where shares of stock are sold after the tax has been assessed, but prior to the time it is paid by the corporation on behalf of the stockholders, the one holding the stock on the date when a tax became due and payable is the one entitled to report the amount as a dividend and deduct the amount as a tax paid by him.[29] Taxes paid to a State by various corporations upon shares of their stock owned by another corporation, are not deductible from

was not a tax upon the bank or upon its property. (T. D. 1763; but see U. S. v. Guaranty Trust & Savings Bank, 253 Fed. 291.) This rule was continued under the 1913 Law and the 1916 Law, such taxes being held to be against the property of the private stockholders and not against either the corporation or its property. (The Northern Trust Company v. McCoach, 215 Fed. 991; T. D. 2135.) The requirements of a State law that a bank shall pay for the stockholder cannot be construed as authority under which the bank may deduct the tax. (T. D. 2161.) Where a statute requires the bank to pay the tax and gives it a lien upon the shares, the bank is not entitled to deduct the tax. (Eliot National Bank v. Gill, 210 Fed. 833, affirmed 218 Fed. 600; National Bank of Commerce v. Allen, 211 Fed. 743, affirmed 223 Fed. 472, petition to the United States Supreme Court for writ of certiorari denied October 25, 1915.) Where the statute gives the bank the option either to pay the tax out of its general funds or to collect the same from its stockholders, that fact does not change the character of the tax as a tax against the property of the individual stockholders, and the bank cannot deduct. (Northern Trust Co. v. McCoach, 215 Fed. 991.) Even though the state statute makes no provision for recovery from the several shareholders of their proportional part of the amount so paid, the bank cannot deduct. (First Nat. Bank v. McNeel, 238 Fed. 559.) The absence of an express provision in the statute does not show that there is no such right of recovery, or that the intention was for the tax to fall ultimately upon the bank and not upon the stockholders. (Home Savings Bank v. Des Moines, 205 U. S. 503.)

27 Reg. 45, Art. 566; T. D. 2135.

28 Reg. 45, Art. 566. See Chapter 19.

29 Letter from Treasury Department dated February 25, 1916; I. T. S. 1918, ¶ 490. An earlier ruling in a letter dated March 2, 1915, held that the stockholder owning the stock at the time the taxes were assessed was the one entitled to the deduction, but the later ruling referred to above seems to indicate the present attitude of the Treasury Department.

gross income of this latter corporation as taxes "paid by it," such taxes not being paid by this corporation, but being paid in its behalf by other corporations.[30]

[30] T. D. 2927; U. S. v. Aetna Life Ins. Co., 260 Fed. 333.

CHAPTER 25

DEDUCTION OF LOSSES

The Revenue Act of 1918 provides in the case of individuals that in computing net income they may be allowed as deductions, if sustained during the taxable year and not compensated for by insurance or otherwise, (a) losses incurred in trade or business, (b) losses incurred in any transaction entered into for profit, though not connected with the trade or business, (c) losses of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty or from theft.[1] The extent to which losses may be deducted by non-resident aliens and foreign corporations is more fully discussed in previous chapters.[2] Individuals and corporations may also deduct debts ascertained to be worthless and charged off within the taxable year.[3] In the case of corporations all losses sustained during the taxable year and not compensated for by insurance or otherwise may be deducted.[4] The rules discussed in this chapter are those applicable to corporations and individuals generally. The Revenue Act of 1918 contains a new provision for the deduction of net losses in certain cases from the income of the preceding year,[5] and also a provision as to losses in inventory and from rebates ascertained after the close of the taxable year.[6]

Losses Sustained in Trade. Under the present and preceding laws losses sustained during the taxable year and not compensated for by insurance or otherwise, may be deducted if incurred in trade or business.[7] A loss incurred in trade or business must be absolute and not a speculative or fluctuating valuation of a con-

1 Revenue Act of 1918, § 214 (a), 4, 5, 6. Reg. 45, Art. 141.

2 See Chapters 4 and 10.

3 Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

4 Revenue Act of 1918, § 234 (a) 4.

5 See p. 388.

6 See p. 389.

7 Revenue Act of 1918, § 214 (a) 4; Reg. 45, Art. 141.

tinuing investment, and must be determined and ascertained to be an actual, a completed, a closed transaction.[8]

Losses Not Sustained in Trade. Under the present law citizens and residents may deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business.[9] It will be noted that in this provision the present law makes an important departure from the 1916 Law and permits the deduction of all losses incurred in transactions entered into for profit though not connected with a trade or business, notwithstanding that such losses may exceed the profits arising from the same class of transactions. A loss in the sale of an individual's residence is ruled not to be deductible. Losses in illegal transactions are not deductible.[10]

Trade or Business. Under the 1916 Law, the term "trade" and the term "business" were defined as synonymous terms and to be, "That which occupies and engages the time, attention and labor of any one for the purpose of livelihood, profit, or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment." The doing of a single act incident-

8 Reg. 45, Art. 141; T. D. 1989. Depreciation in the value of property is treated as a separate deduction and should not be confused with loss.

9 Revenue Act of 1918, § 214 (a) 5. Under the 1916 Law, a citizen was permitted to deduct the losses actually sustained in transactions entered into for profit but not connected with his business or trade only to an amount not exceeding the profits arising therefrom. A loss was required to be actually sustained during the year and the total amount deductible could not exceed the profits arising from the same class of transactions. (Revenue Act of 1916, § 5.) Thus, an individual making any investments in property from time to time or speculating was required to report all gains from such investments or speculations and might offset against the gains all losses sustained in similar transactions. He was required to report only the net gain from such transactions during the year, and if the net result for the year of a series of such transactions was a loss, he was not entitled to offset the loss against his income from trade or business. Prior to the 1916 Law it was held by the Treasury Department that an individual was required to report all income from transactions not incurred in trade, but was not entitled to deduct any of the losses. (T. D. 2135.)

10 Reg. 45, Art. 141. The validity of the rule as to loss on the sale of a residence may be questioned unless it is conceded that a gain on such sale is not taxable.

ally or of necessity not pertaining to the particular business of the person doing the same will not be considered engaging in or carrying on business.[11] "In trade," as used in the 1916 Law, is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money, otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may be engaged in more than one trade and may deduct losses incurred in all of them under this provision of the law, provided that in each trade the above requirements are met. Losses on stocks, grain, cotton, etc., may also be deducted under this provision by a person engaged in the trade to which buying or selling thereof are incident as a part of the business, as by a member of a stock, grain or cotton exchange,[12] but neither the investment of money in the stock of a company nor employment by the company in any official capacity makes the business of the company the trade of the investor or employee.[13] The losses which were limited by this provision of the 1916 law were those incurred in transactions involving sales or dealings in property. The law seemed clearly to make a distinction between such

11 T. D. 1989.

12 T. D. 2090.

13 T. D. 2135. The definition of "trade or business" discussed in the text above has now lost considerable importance in view of the provision (Revenue Act of 1918, § 214 (a) 5) that losses incurred in any transaction entered into for profit may be deducted even though such losses exceed the profits arising from the same class of transactions. Under the 1916 Law, it will be noted, the Treasury Department adopted an extremely narrow construction of the words "business or trade," a construction which has been the subject of considerable criticism and which operated to the detriment of every person investing or speculating in property. Congress has now seen fit to remedy the injustice involved in this narrow construction by permitting the deduction of all losses in transactions entered into for profit even though they may exceed the profits arising from the same transactions (Revenue Act of 1918, § 214 (a) 5). Consequently the definitions of "trade or business" discussed in the text above are no longer so important except in cases arising under the 1916 and 1913 Laws. In Bryce v. Keith, 257 Fed. 133, arising under the 1913 Law, the Court has adopted a broader construction of the term "trade" than the Treasury Department. In this case it was held that loss of the value of corporate stock, acquired by numerous transfers of property to the corporation and payment of corporate debts, transactions carried on for a considerable period, complicated in character and involving large sums of money so that they must have required much time and attention, was a loss incurred in trade.

losses and losses arising from fires, storms, shipwreck, or other casualty, and from theft.

Losses Must Be Sustained During Year. The 1916 Law provided in the case of individuals that the loss must be "actually sustained during the year" and in the case of corporations that the loss must be "actually sustained and charged off within the year."[14] The Revenue Act of 1918 omits the word "actually" in the case of individuals and the words "actually" and "and charged off" in the case of corporations. The Treasury Department holds that a loss to be deductible must be an absolute loss, actually sustained and ascertained during the taxable year for which the deduction is sought to be made. It must be determined and ascertained upon an actual, a completed, a closed transaction. Losses sustained from the sale or dealing in real or personal property growing out of the ownership or use of, or interest in, such property will not be deductible at all unless they are ascertained, determined and fixed as absolute in the above sense within the taxable year in which the deduction is sought to be made.[15] The amount to be deducted as a loss should have in it no element of "depreciation" or "allowance for wear or tear" or "compensation from insurance or otherwise." The amount is to be an absolute and complete loss which has been actually sustained.[16]

Losses of Capital. What the law contemplates as a deduction is the loss of capital,[17] either by the sale of property or by the

14 Revenue Act of 1916, § 12(a).

15 Reg. 45, Art. 141; T. D. 2005. See, however, the special rules at the end of this chapter.

16 T. D. 2005. Under the 1916 Law, in the case of corporations, the loss might not be deducted unless it was actually sustained during the year and charged off on the books. It was held that a corporation was not entitled to a deduction for a loss unless charged off on the books of the corporation before such deduction was allowed. The statute was not to be construed as requiring that losses be charged off within the taxable year. It was sufficient that they were charged off before they were allowed as deductions. Consequently at the time of an examination of a corporation it was given an opportunity to reopen its books and charge off losses which it had actually sustained during the taxable year. (Letter from Treasury Department dated June 25, 1918; I. T. S. 1918, ¶ 3599.) This rule seemed to apply with equal force in the case of an individual who kept books, but one who did not keep books was not thereby deprived by the law of the right to claim a loss, except in the case of worthless debts.

17 It is interesting to note that under the Civil War Income Tax Laws, losses

destruction or disappearance of property. It is, therefore, immaterial in what year the capital was created so long as the loss is sustained in the taxable year. All losses to be deductible, if not sustained in trade or business, must result from transactions entered into for profit,[18] or must be losses of property arising from fires, storms, shipwreck, or other casualty or from theft. It has been held that a distribution of dividends by a corporation, whether from capital or from surplus, is not a deductible loss.[19]

Losses of Income. Loss of income is not, generally speaking, a proper deduction. If, for instance, a debtor defaults in payment of interest, or a corporation fails to pay a regular dividend, or an employer fails to pay commissions or salaries, the amount of such items may not be deducted from other income during the year, as the income is reduced by the mere fact that such sums are not included. If, however, the taxpayer has reported any such amounts as income for the taxable year, or a preceding year, as might be done in the case of taxpayers reporting on a basis other than that of actual receipts and disbursements, the subsequent failure to collect the amounts so entered on the books may be treated as a loss when it is determined that the amount is not collectible.[20]

Measure of Loss. In the case of the sale of assets the loss will be the difference between the cost thereof, less depreciation sustained since acquisition, or the fair market value as of March 1, 1913, if acquired before that date, less depreciation since sustained, and the price at which they were disposed of. When the loss is claimed through the destruction of property by fire, flood or other casualty, the amount deductible will be the difference between the cost of the property or its fair market value as of March 1, 1913, and the salvage value thereof, after deducting

of capital were not deductible. (See Letter from Treasury Department dated June 8, 1865, 2 Int. Rev. Rec. 36.)

18 Under the 1916 Law it seemed that a deductible loss need not necessarily be one connected with the business or trade of an individual, except in the case of losses resulting from sales or dealings in property, in which case it was expressly provided that such losses must be incurred in his trade or business. The Revenue Act of 1918 seems to intend that losses resulting from such sales or dealings may be deducted not only when connected with his trade or business, but when not so connected, if in transactions entered into for profit.

19 Van Dyke v. Milwaukee, (Wis.) 150 N. W. 509.

20 This point is discussed in the paragraph below on worthless debts.

from the cost or value as of March 1, 1913, the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained. But the loss should be reduced by the amount of any insurance or other compensation received.[21] In a case arising under the 1909 Law, the court said: "There seems to be no limitation provided in the act as to the amount of deductions to be allowed for losses actually sustained from any source during the year, and whether due to conditions of business, the sale of property, or anything else, and the court must, therefore, assume that the statute contemplated that the full amount of all losses sustained within the year would be allowed.[22]

Losses from Sales of Property. The most frequent deductions for losses are claimed as a result of the sale of property. In such cases the loss occurs when the selling price is less than the cost. This is the converse of gain from the sale of property which is discussed in a preceding chapter.[23] The cost of the property is determined in the same manner whether the transaction results in a loss or a gain and the same rules apply with respect to property acquired prior to March 1, 1913.

SALE BY CORPORATION OF CAPITAL ASSETS. If a corporation sells its capital assets for less than their cost, or fair market value as of March 1, 1913, if acquired prior thereto, the loss sustained is deductible.[24]

Losses from Exchanges of Property. Where property is exchanged for other property, the property received in exchange is treated, for the purpose of determining any loss to the taxpayer, as the equivalent of cash to the amount of its fair market value, if any.[25] If the property received in exchange has no fixed value

21 Reg. 45, Art. 141; Reg. 33 Rev., Art. 147; T. D. 2090.

22 Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206. In this case the court required the corporation to report as income all of its profits and permitted it to deduct all of its losses on the sale of property during the year, regardless of the fact that some of the property was purchased prior to the incidence of the tax, it appearing that the result would be the same as if the gains and losses had been pro-rated as then required by the Treasury Department.

23 See Chapter 17.

24 Reg. 45, Art. 563.

25 Revenue Act of 1918, § 202 (b).

or definitely ascertainable market value, it would be difficult to determine the amount, if any, of loss in the transaction and it does not seem that any loss can be claimed by the taxpayer.

Exchange of Stock. The Revenue Act of 1918 provides[26] that "when in connection with the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Where in such an exchange a person receives for his stock or securities, new stock or securities of a greater par or face value then a gain is presumed and a method is provided for determining the amount of such gain.[27] No provision is made for determining and allowing the deduction of a loss when the new stock or seucrities received are of less par or face value than those exchanged. It is expressly stated in the law, as quoted above, that where the new stock or securities received are of no greater par or face value than those exchanged no gain or loss shall be deemed to occur from the exchange. Where in a case of merger, stockholders of one corporation exchanged their stock for stock of the corporation resulting from the merger and received a par value less than the par value of the old stock, it was held under the 1916 Law that the transaction constituted a sale for income tax purposes, and that a deduction might be claimed for any loss measured by the difference between the value of the old stock on March 1, 1913, (or the cost, if purchased subsequent to that date) and the value at which the same stock was given in exchange for stock of the company resulting from the merger.[28]

Bonds Purchased Above Par. Where bonds have been purchased above par it seems, under the present law, that no deduction can ordinarily be made for the loss of the amount of the premium until the bonds are either sold in the market before ma-

[26] Revenue Act of 1918, § 202 (b).

[27] Revenue Act of 1918, § 202 (b).

[28] Letter from Treasury Department dated March 9, 1917; I. T. S. 1918, ¶ 1305. See Chapter 17. Under the 1916 Law such losses were permitted to be deducted in the case of individuals only to the extent that they did not exceed gains from other similar transactions during the year.

turity, or until the principal sum is received at the time of maturity. In either case the losses will be the difference between the amount paid and the amount received. Where, however, a taxpayer reports on a basis other than of actual receipts and disbursements it seems that this sum may properly be deducted in proportionate amounts each year as amortization.[29]

Loss by Destruction or Disappearance of Property. The law expressly provides, in the case of individuals, that the loss arising from fires, storms, shipwrecks, or other casualty, or theft, may be deducted in the year in which the loss is sustained.[30] This kind of loss is allowed to corporations without specific mention, as with respect to corporations all losses are deductible. In the case of non-resident aliens the law permits the deduction of all such losses of property within the United States.[31] In the case of foreign corporations such deductions are allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of such deductions with respect to sources of income within and without the United States must be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[32] In all cases the law provides that the deduction may be made only when such losses are not compensated for by insurance or otherwise. The intent seems to be to permit a deduction of the losses to the extent that the tax payer is not compensated by insurance or otherwise. If he is compensated for part of such loss, he may deduct the part for which he is not so compensated. In claiming a loss due to the destruction of property the salvage value of the property must be considered as a partial compensation to be deducted from or not included in the amount claimed as a deduction. The value of the property at the time of the loss is not intended to be the measure of the loss. The loss will be the difference between the fair market value as of March 1, 1913, or the cost of the prop-

29 This was also the case under the 1916 Law. Under the 1909 Law it was held that where bonds were purchased at a rate above par a proportionate amount of the premium might be deducted each year on account of amortization (T. D. 1727). See Van Dyke v. Milwaukee, (Wis.) 150 N. W. 509.

30 Revenue Act of 1918, § 214 (a) 6.

31 Revenue Act of 1918, § 214 (a) 6.

32 Revenue Act of 1918, § 234 (b).

erty, and the salvage value thereof, including in the latter value the amount, if any, which has been or should have been set aside and deducted in the current or previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained.[33]

Voluntary Destruction of Property. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements has been held to be deductible from gross income, in a sum representing the difference between the cost of such property demolished or scrapped and an amount measuring a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost, less salvage, as would have remained unextinguished if a reasonable allowance had been charged off for depreciation during each year prior to its destruction. When a taxpayer buys real estate, upon which is located a building which he proceeds to raze, with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.[34]

Loss of Useful Value. When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation allowances) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where machinery or other

[33] Reg. 45, Art. 141; Reg. 33 Rev., Art. 147.

[34] Reg. 45, Art. 142; Reg. 33 Rev., Arts. 155 and 156. See Reg. 33, Art. 127.

property must be replaced by a new invention, or where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income.[35]

Cost of Drawings, Models and Patterns. Expenditures made for designs, drawings, patterns or models representing work of an experimental nature should be treated as a capital disbursement and not as an expenditure if the designs, drawings, patterns or models prove to be satisfactory and result in the production of salable goods. If, however, they prove to be unsatisfactory and have no asset value, the expenditure may be charged off as a loss incident to running the business and as such deducted from gross income, provided that the taxpayer taking credit for such expenditures in the income tax return makes a full and complete explanation with respect to the same.[36] If designs, drawings, patterns, or models result in the production of goods which prove to be salable for a certain length of time

35 Reg. 45, Art. 143. Under the Hawaiian Law, which does not make any provision for a deduction to cover obsolescence, it has been held that no deduction may be taken to cover the value of mills, buildings, and a railroad discarded on account of the erection of a larger mill at a different location and the construction of a different railroad connected therewith. This transaction was held not to be deductible either as a loss or an expense and it was also held that the provision that "no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments made to increase the value of any property or estate," did not imply that deduction might be made for all amounts so paid out which did *not* in fact increase the value of the property. (Haw. Commercial, etc., Co. v. Tax Assessor, 14 Haw. 601, 687.)

36 Reg. 33 Rev., Arts. 175, 176.

and then become obsolete and can not be sold, the amount expended for such designs, drawings, patterns, or models, less any amounts previously claimed as depreciation with respect to the same or as a return of capital, may when charged off, be included in, and deducted as a loss incident to running the business, provided full and complete information is reported in a manner satisfactory to the Commissioner.[37]

Amounts Paid to Make Up Profits of Another Corporation Under Agreement. Contracts guaranteeing the payment of dividends or interest of one corporation by another are frequently made between corporations having close business relations. Whether or not amounts paid under such contracts or guarantees may be deducted, as a loss or as an expense of doing business, by the paying corporation has not been determined by the courts in this country. In England such payments have been held properly deductible as sums expended for the purpose of trade.[38] If the payment is made under an enforceable contract, there seems to be no reason why the amount should not be deducted either as loss or expense. This question would seem under the present law to be covered in many cases by the provision for the making of a consolidated return by affiliated corporations.[39]

Shrinkage in Securities and Stocks. A person possessing securities such as stocks and bonds, can not deduct from gross income any amount claimed as a loss on account of the shrinkage in value of such securities through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the securities mature or are disposed of. In the case of banks or other corporations which are subject to supervision by State or federal authorities, and which in obedience

[37] Reg. 33 Rev., Art. 177.

[38] Moore v. Stewarts & Lloyds (1906), 8 Fraser 1129. In this case it was observed that the question was one of fact rather than of law. One company entered into agreement with another whereby in return for the right to nominate a majority of directors of the second company the first undertook to pay to the second such sums each half year as might be necessary to make up any deficit in the dividends on the latter's preferred shares. The court said, "If the agreement was entered into with a view to profit, as I think it was * * * then the annual charge to the respondent company is in my view a part of their business outlay or expenditure and is not subject to assessment."

[39] See Chapter 10.

to the orders o. such supervisory officers charge off as losses amounts representing an alleged shrinkage in the value of property, the amounts so charged off do not constitute allowable deductions. The foregoing applies only to owners and investors, and not to dealers in securities. However, if stock of a corporation becomes worthless, its cost or its fair market value as of March 1, 1913, if acquired prior thereto, may be deducted by the owner in the taxable year in which the stock was ascertained to be worthless and charged off, provided a satisfactory showing of its worthlessness be made as in the case of bad debts.[40]

Worthless Stock. If stock of a corporation becomes worthless its cost, or its fair market value as of March 1, 1913, may be deducted by the owner in the taxable year in which the stock was ascertained to be worthless and charged off. The worthlessness must be satisfactorily shown as in the case of bad debts.[41]

Sale of Capital Stock. Where the capital stock of a corporation is issued for less than par, the amount of discount is not an allowable deduction to the corporation. Such a transaction is purely a capital transaction and the income of the corporation is not directly decreased by reason of the sale of the stock at a price less than its par value. Neither is any loss or gain realized from the purchase of its own stock.[42]

Voluntary Payment by Stockholders of Loss of Corporation. Assessments made by a corporation on its capital stock are regarded as an investment of capital and the amounts paid do not constitute allowable deductions to the stockholders.[43] This rule was held to apply in a case where a corporation showed a deficit at the close of the year and the stockholders agreed to make it good by the payment of voluntary contributions.[44]

40 Reg. 45, Art. 144; Letter from Treasury Department dated August 14, 1914; I. T. S. 1918, ¶ 1344; N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576. The Act of June 30, 1864, as amended by the Act of July 13, 1866, seems to have permitted the deduction from *earnings* of depreciation in investments in bonds and depreciation in stock in order to arrive at the amount of the taxpayer's *profits*. (Miami, etc., R. R. Co. v. U. S., 108 U. S. 277.)

41 Reg. 45, Art. 144; T. D. 2135. See p. 383 for a discussion of the deduction of bad debts.

42 Reg. 45, Arts. 563, 542; T. D. 2090.

43 T. D. 2090.

44 Letter from Treasury Department dated February 21, 1916; I. T. S. 1918, ¶ 1291.

Shrinkage or Deterioration in Storage. Loss due to shrinkage or deterioration of produce in storage is not allowed as a deduction. Such shrinkage or deterioration is reflected in the selling price when the goods are sold and correspondingly reduces the net income at that time.[45]

District Irrigation Bonds. District irrigation bonds as a rule, if not always, are a lien upon the real estate affected by the irrigation project and until the corporation has taken such steps as are necessary to protect its rights and enforce the collection of the bonds, it does not appear that the corporation would be warranted in writing out of its assets and deducting from gross income, as a loss, the face value, or any other arbitrarily ascertained amount, representing a loss or shrinkage in the value of such bonds.[46]

Losses of Oil and Gas. Losses of oil and gas are of two kinds: (a) Those which are unforeseen or unavoidable, such as losses sustained through fire or accident; and (b) losses that are anticipated and recognized as unavoidable under operating conditions, such as evaporation of oil in storage, ordinary leakage, refinery losses, etc. Usually the latter class are indeterminate as to amount and are absorbed either implicitly or explicitly in current operating expenses or in cost of the oil or gas. Indeterminate losses may not be deducted from gross income.[47]

Reserves for Losses. Reserves to take care of anticipated or probable losses are not a proper deduction.[48] On the other hand, losses sustained during the year may be deducted although made good out of a fund which has been accumulated as an insurance reserve by the taxpayer.[49]

Worthless Debts. The Revenue Act of 1918 provides that individuals and corporations may deduct debts ascertained to be worthless and charged off within the taxable year.[50] For the purpose of deduction as losses, debts are divided into two classes, (a)

45 Reg. 45, Art. 145; T. D. 2153.

46 T. D. 2152.

47 Manual for Oil and Gas Industry, p. 18.

48 Reg. 33 Rev., Art. 166; T. D. 2161. Reserves to take care of the depreciation or obsolescence of property used in the trade or business of the taxpayer are permitted as deductions as set forth in Chapter 26.

49 Reg. 33, Art. 122.

50 Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

those which represent to the creditor a return of capital and (b) those which represent unpaid income. The former may be deducted regardless of when the debt became due and payable, but the latter, such as uncollected wages, salaries, rents, interest and similar items of taxable income, may not be deducted, if the debt became due on or after March 1, 1913, unless the amount thereof has been reported as income; but if the debt became due and payable prior to March 1, 1913, it may be deducted in any event.[51] The losses which may be deducted are losses of capital; income on which the tax has been assessed assumes the status of capital, and income which became due and payable before the incidence of the tax is capital to the taxpayer, although it may be received thereafter. The mere failure to receive income does not warrant a deduction, as the omission of such amounts operates, in itself, as a reduction of tax. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation. In the case of debts existing prior to March 1, 1913, only their value on that date may be deducted upon subsequently ascertaining them to be worthless. An account merely written down or a debt recognized as worthless prior to the beginning of the taxable year is not deductible.[52] Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt. The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of deduction to be based upon the price he paid for them and not upon their face value.[53]

MUST BE CHARGED OFF ON BOOKS. The Revenue Act of 1918 expressly provides that in the case of both individuals and corpora-

51 T. D. 2224.
52 Reg. 45, Art. 151.
53 Reg. 45, Art. 152.

tions worthless debts must have been "charged off" in the year in which they are claimed as a deduction.[54]

WHEN DEBTS MAY BE CONSIDERED WORTHLESS. To determine whether or not a debt is worthless it is not essential that an unsatisfied judgment shall exist or a judicial determination be reached or that the bad debt or account shall be proved worthless by legal proceedings. Before a deduction will be allowed the taxpayer must, however, not only be satisfied that the debt or account is worthless, but must be able to satisfy the Commissioner or Collector that the accounts charged off were definitely determined at the time to be worthless and that they had not been recognized as worthless or without value prior to the beginning of the year for which the return is made.[55] Bankruptcy may or may not be an indication of the worthlessness of a debt, and actual determination of worthlessness in such a case is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year confirming the conclusion that the debt is worthless will not authorize shifting the deduction to such later year.[56] Where an indebtedness is claimed and contested and a settlement is had by way of compromise whereby an amount, less than the debt claimed, is accepted in full payment and satisfaction of the debt, the difference between the amount paid and that claimed is not allowable as a deduction for worthless debts. If the settlement in compromise consists of a promise to pay an amount less than the debt claimed, an accord and satisfaction is established and the amount promised to be paid forms the basis of a new transaction. Upon the breach of this promise the question will arise as to the deductibility of the new amount only.[57] Whenever the debtor is legally discharged from his obligation either by the running of the statute of limitations, by bankruptcy proceedings, by accord and satisfaction, by formal release, or by any other

[54] Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

[55] Reg. 33 Rev., Art. 151; Reg. 45, Art. 151.

[56] Reg. 45, Art. 151.

[57] Reg. 33 Rev., Art. 8. This regulation reversed the Treasury Department's previous ruling that the unpaid portion of a compromised debt might be claimed as a deduction.

method, it seems that the creditor may claim the amount of loss sustained as a deduction. As indicated by the ruling above, it may be possible under other conditions to deduct the amount of a debt but the circumstances must be such as to indicate beyond doubt that the debt cannot be collected. Where all of the surrounding and attendant circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would not in all probability result in the satisfaction on execution of a judgment, a showing of these facts will be sufficient showing of the worthlessness of the debt for purposes of deduction.[58] A mere voluntary forgiveness of the debt would not make the amount thereof an allowable deduction, since such voluntary action on the part of the creditor would be tantamount to a gift.

FORECLOSURE OF MORTGAGES. Where, under foreclosure, a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price the difference between the purchase price and the indebtedness will not be allowable as a deduction as a bad debt. The property which was security for the debt, being in possession and ownership of the mortgagee, is held for the purposes of income tax, to be sufficient to justify a disallowance of a claim for bad debt. The determination of loss in such a situation is deferred until the property is disposed of, except where a purchase money mortgage is foreclosed by the vendor of the property. Only where a purchaser for less than the debt is another than the mortgagee may the difference between

[58] Reg. 45, Art. 151; Reg. 33 Rev., Art. 8; U. S. v. Mayer, 26 Fed. Cas. No. 15, 753. In U. S. v. Frost, 25 Fed. Cas. No. 15,172, a prosecution for making a false income tax return for the year 1866, the court made the following observation regarding the provision of the statute permitting the deduction of worthless debts: "The language is, 'ascertained to be worthless'. By whom or how? The law is silent on this important point, and therefore there must be a discretion given to the person making his returns, and if that discretion is used fairly and honestly there would seem to be no just ground of complaint. It certainly can scarcely be contended that every debt must be ascertained to be worthless by a suit at law, or in equity, for that would be impracticable, and therefore such cannot be the meaning of the law. It is undoubtedly very difficult to lay down any rule of universal application to this class of cases, and yet the want of precision in the law may have led to this prosecution, and may lead to others, and, perhaps, on the whole, it would be better to give, by law, a clearer and simpler definition than now exists of the terms 'gains, profits and income'."

the debt and the net selling price credited be deducted as a bad debt.[59]

WORTHLESS SECURITIES. Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them, but not exceeding their amortized value if purchased at a premium. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established.[60]

Loss Due to Adverse Judgment. In a case where a corporation was sued for infringing a trade name covering a period ending in 1912, and judgment was obtained against it in 1916, the Treasury Department held that the amount of this judgment should be prorated over the period ending in 1912 according to the income of each year. The part found by this method to be applicable to the income of the corporation for the period 1909 to 1912 would be referable to those years, but no part of this sum would be deductible as a loss in the return of income for 1916. The same corporation also paid, in 1916, an additional sum, as consideration for dismissal of a pending suit for interest on the above judgment from the date of the decision of the court to the date of payment and for the unrestrained use of the trade name in question. It was held by the Treasury Department that if this amount could be segregated between interest and use, it might be prorated the same as in the other case, for the period subsequent to 1912, and such part thereof as would be found applicable to the 1916 income would be deductible under the heading of business expense and interest respectively. If no segregation could be made the

59 Reg. 45, Art. 153; Reg. 33 Rev., Art. 8.
60 Reg. 45, Art. 154.

entire amount might be treated as business expense.[61] The language of the present law differs from that of preceding laws in that it permits the deduction of losses sustained during the taxable year, whether charged off or not, and seems to imply that the loss shall be deducted from the net income of the year in which it was sustained notwithstanding the ascertainment thereof through an adverse judgment in a subsequent year.[62] If on suit for damages the amount recovered is less than the damage sustained or less than an amount necessary to make good the damage, the difference between the actual amount of damage sustained and the amount recovered will be deductible as a loss by the judgment creditor or prevailing party.[63]

Net Losses. The Revenue Act of 1918 contains a new provision for the allowance of certain "net losses." When used in connection with this provision of the law the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the *bona fide* sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the recent war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations amounts received as dividends from a corporation taxable upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed) over the sum of the gross income plus any interest received free from income or excess-profits taxes. The amount of net loss claimed must represent an actual net loss over and above all income, including tax-free income. Such losses will be allowable only in respect of a taxpayer having a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, and after one claim has been allowed no further claim can be considered. It is further provided that the benefit of the provisions respecting the allowance of net losses may be allowed to the members of a partnership and the beneficiaries of an estate or trust under regu-

61 Letter from Treasury Department dated February 9, 1917; I. T. S. 1918, ¶ 1427.

62 See Revenue Act of 1918, §§ 214 (a) 4, 5, 6, and 234 (a) 4.

63 Reg. 33 Rev., Art. 94.

lations prescribed by the Commissioner with the approval of the Secretary.[64]

CLAIM FOR ALLOWANCE OF NET LOSS. A taxpayer having such a net loss may file a claim on form 46 with his return of income for the taxable year 1919. Such claim should contain a concise statement setting forth the amount of the loss sustained, in accordance with the accompanying return, the nature of the loss, the amount of the taxpayer's net income for the taxable year 1918, the taxes paid by him with respect thereto, and all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim.[65]

ALLOWANCE OF NET LOSS. The amount allowed by the Commissioner in respect of any such claim will be deducted from the net income for the taxable year 1918 and the income and the war-profits and excess-profits taxes, if any, for such year will be recomputed accordingly. Any amount found to be due him will be credited or refunded to the taxpayer. In any case in which it is found by the Commissioner that such net loss is in excess of the net income of such preceding taxable year, the taxpayer may carry forward the amount of such excess and claim it as a deduction in computing net income for the succeeding taxable year.[66]

Losses in Inventory and from Rebates. The Revenue Act of 1918 contains a new provision regarding losses sustained after the close of the taxable year 1918. It is provided that a taxpayer may file, at the time of filing return for the taxable year 1918, a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other

64 Revenue Act of 1918, 204; Reg. 45, Art. 1601. The following statement contained in the Senate Committee report upon the Revenue Act of 1918, throws additional light upon § 204 of the statute providing for the deduction of net losses: "One of the most important provisions inserted by the committee is quite new to our tax laws. At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross income the excess (or in other words, the net loss) can not be carried over into the next year. For purposes of taxation the settlement must be made upon the basis of each year's business by itself. The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice."

65 Reg. 45, Art. 1602.

66 Reg. 45, Art. 1603.

disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by the claim is not required until the claim is decided, but the taxpayer must accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed, the remainder of the tax due must, on notice and demand by the collector, be paid by the taxpayer with interest at the rate of one per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the income tax the amount of such loss will be deducted from the net income. Where no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described, the amount of such loss will be deducted from the net income for the taxable year 1918 and the income tax imposed for such year will be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination will be credited or refunded to the taxpayer.[67] These deductions may be secured by two methods, either by a claim in abatement or by a claim for refund, and must not be entered upon the regular return.[68]

LOSS IN INVENTORY. Inventory losses are allowable either (a) where goods included in an inventory at the end of the taxable year 1918 have been sold at a loss during the succeeding taxable year, or (b) where such goods remain unsold throughout the taxable year 1919 and at its close have a then market value (not resulting from a temporary fluctuation) materially below the value

67 Revenue Act of 1918, §§ 214 (a) 12, 234 (a) 14.

68 Reg. 45, Art. 261; Telegram from Treasury Department dated March 3, 1918; I. T. S. 1919, ¶ 3276. Copies of inventories need not be filed with the return but taxpayers should retain for a period of not less than five years all original inventory sheets and all papers which would have any bearing on a claim for loss in inventories (including sales slips). (I. T. S. 1919, ¶ 3358).

at which they were inventoried at the end of the taxable year 1918. No deduction is allowable for losses of anticipated profits or for losses not substantial in amount, nor for physical damage or obsolescence occurring in the taxable year 1919. If, for example, the inventory contained discontinued off colors in broken lots and the salable colors had been disposed of and the stock broken before the close of the taxable year 1918, the element of obsolescence if definitely determined should be taken into account in both the inventory made at the close of the taxable year 1918 and that made at the close of the taxable year 1919. If it is impossible to get the market value for such colors in broken stocks, the taxpayer will be required to await the sale of such broken stocks in order to determine the loss involved; but in most instances a reasonable and fair estimate of the market value can be made. If the salable colors were disposed of after the close of the taxable year 1918, the accompanying obsolescence in the remaining stock takes place in the year 1919 and the deduction must be taken not as a loss in inventory but as obsolescence occuring in the taxable year 1919.[69] In determining whether goods included in an inventory at the end of the taxable year 1918 have been sold during the succeeding taxable year, and whether loss has resulted therefrom, sales of goods made in the taxable year 1919 will be deemed to have been made from the inventoried stock of 1918 until such inventoried stock is exhausted.[70] All goods where title has actually passed to the taxpayer must be included in the inventory, and as a result thereof are eligible for consideration in any claim in abatement. It is necessary that title shall have passed to the taxpayer in 1918, and goods merely ordered for future delivery and for which no transfer of title has been effected, should be excluded. Where a taxpayer's fiscal year ended on November 30, 1919, and inventory is taken on that date, the claim in abatement can only apply to goods which are the property of the taxpayer up to that date, but no claim can be made on any materials which have become the property of the

[69] I. T. S. 1919, ¶ 3363. Much of the text of this and the following paragraphs on losses in inventory is based upon the published answers of the Advisory Board to a series of questions submitted by the Southern Wholesale Drygoods Association in May, 1919.

[70] Reg. 45, Art. 263.

taxpayer between December 1 and 31, inclusive, of that year.[71] Where a claim for inventory loss is finally allowed, the net income for 1919—as established by usual accounting methods—will be correspondingly higher as reported in the return for the taxable year 1919. In other words, the item of loss which would normally find its way into 1919 operating accounts is thrown back against 1918 income. It is recommended that the accounting records of the taxpayer be not changed but that any adjustment of inventories be recorded in distinct accounts supported by adequate detailed schedules. In arriving at the net operating profits for any year, the income, excess and war-profits taxes to be paid on such profits are not taken into consideration. Such taxes, therefore, are theoretically paid out of surplus for the year. If at a subsequent date any of such taxes are refunded, they should not be recorded in the operating accounts, but should be credited directly to surplus.[72]

Loss from Rebates. Where after the close of the taxable year 1918 rebates have been *bona fide* paid in pursuance of contracts entered into during such year upon sales made during such year, the net income for that year may be reduced by the deduction of the amount of such rebates actually paid. No such deduction will be allowed unless the profits from such sales have been included in the income for the taxable year 1918.[73] In cases where rebates have been made on sales reported in the 1918 return of income, a separate schedule should be submitted and the total thereof may be included in the taxpayer's claim in abatement. This schedule should be prepared in such manner as to reflect: (a) the date of each rebate; (b) the name and address of each party securing the benefit thereof; (c) a description of the goods; (d) the quantities; (e) the sales value of each item; and (f) the amount rebated. Rebates made during the taxable year 1919 on sales made during such year (provided the goods to which the rebate applies were included in the inventory at the close of the taxable year 1918) will be considered as an adjustment of sales values in arriving at the loss on inventories for the taxable year 1918. This item cannot go in the rebate claim, but the rebate may

71 I. T. S. 1919, ¶¶ 3360, 3361; see Reg. 45, Art. 1561.
72 I. T. S. 1919, ¶ 3369.
73 Reg. 45, Art. 262.

be considered in determining the sale price for the purpose of determining an *inventory* loss. It must be understood that rebates made on goods acquired and sold subsequent to the end of the taxable year 1918 cannot be considered in any manner as a 1918 inventory loss.[74]

LOSS WHERE GOODS HAVE BEEN SOLD. Where goods included in the inventory at the end of the taxable year 1918 have been sold during the succeeding taxable year, the loss which may be deducted from net income for the taxable year 1918 is the amount by which the value at which the goods sold were included in the inventory exceeds the actual selling price minus a reasonable allowance for selling expenses and for manufacturing expenses, if any, incurred in the taxable year 1919 and attributable to such goods.[75]

LOSS WHERE GOODS HAVE NOT BEEN SOLD. Where goods included in the inventory at the end of the taxable year 1918 have not been sold during the succeeding taxable year, the loss which may be deducted from net income for the taxable year 1918 is the amount by which the net income for such year would be reduced if the inventory were redetermined and such goods taken at their market value (ignoring mere temporary fluctuations of value) at the end of the taxable year 1919.[76]

Method of Computing Loss in Inventory. Loose-leaf ledgers are recommended, whereby control can be secured of each classification or lot of goods upon which claim is to be made. Therein should be recorded quantities and values as returned on the inventory at the close of the taxable year 1918; and there should be recorded in summary form each day or week, the quantities sold and the values thereof, and all items of sales should be carried forward, according to established classification adopted by the taxpayer, to the time when the quantities as reported in the inventory shall have been accounted for. At the time of filing the return of income in 1919 the taxpayer was permitted to compute his loss from sales to that date, by deducting from the total

74 I. T. S. 1919, ¶¶ 3364, 3365.

75 Reg. 45, Art. 264. The Treasury Department first held that such loss could not include selling expenses, deductible during the taxable year in which the sale is made. See Telegram from Treasury Department dated March 3, 1919; I. T. S. 1919, ¶ 3276.

76 Reg. 45, Art. 265.

sales a reasonable and proportionate allowance for operating or selling expense. The net result ascertained was to be deducted from the inventory value of the goods included in the 1918 inventory sold to that date, and the resultant loss brought down. The taxpayer was then to reduce the balances remaining unsold to the then market value, and add the loss thus ascertained from sales. The sum total of these computations would represent the total loss upon which the amount of tax to be claimed *in abatement* should be computed and this amount was deductible from the unpaid installments of the tax, *provided,* a proper bond was furnished. Should any goods unsold, upon which claim in abatement had been filed at the time of filing the return, be disposed of by sale at a subsequent time within the taxable year 1919, the taxpayer was to continue to record the sales effected, deducting therefrom the proportionate cost of operating or selling expense. The gain or loss would then be ascertained by computing the difference between the adjusted sales values and the inventory value established at the time of filing the claim in abatement. If at the close of the taxable year 1919 there remained any commodity unsold, the taxpayer can adjust the inventory value to the market price (ignoring mere temporary fluctuations in price or value), at the close of the taxable year and compute the amount of gain or loss. Such gain or loss will be combined with the gain or loss on sales between the time of filing the return and the close of the taxable year 1919. If it is shown that the taxpayer has sustained a loss additional to that shown in the claim in abatement a claim for refund should be made on Form 46 for the amount of tax overpaid. Should it be shown that the amount deducted in the claim in abatement at the time of filing the return for the taxable year 1918 is in excess of the tax based upon actual losses sustained throughout the taxable year 1919, the taxpayer must remit to the collector the additional amount of tax involved with interest at the rate of 1% per month from the time of filing the return until the date of filing the final adjustment of taxes for the taxable year 1918 on account of inventory losses.[77]

[77] See I. T. S. 1919, ¶ 3359.

The following is an example of the computation above outlined:

Assume an inventory at December 31, 1918, 200,000 yds. at 15c.	$30,000

CLAIMS. Claims in abatement could be filed with the collector on form 47 when the return for the taxable year 1918 was made. Where the taxpayer had filed his return, but the total amount of tax has not been collected, a claim in abatement was considered if filed before, or within ten days after the mailing of the collector's

Assume sales, between January 1, 1919, and June 1, 1919, 100,000 yds. at 12½c	$12,500	
Cost of manufacturing or selling based upon data ascertained from 1918 operations, say in this case of 15% of sales values	1,875	
Net proceeds from sales	$10,625	
The inventory cost at 15c per yd. amounted to	15,000	
Net loss upon which tax can be claimed in abatement		4,375
Assume that the market price at June 1, 1919 (on the assumption that the taxpayer will prepare his claim on June 1, rather than delay until June 15, 1919), on this class of goods was 12c. There would remain unsold at that time 100,000 yds. originally inventoried at 15c to be reduced to 12c or at a loss of 3c per yd. aggregating		3,000
Total amount upon which tax could be claimed in abatement at the time of filing the return on or before June 1, 1919, would be		$ 7,375
Now, between June 1, 1919, and December 31, 1919, assume that the taxpayer sells 50,000 yds. at a price of 15c per yard, amount of sale would be	7,500	
Deducting therefrom operating or selling expense at the same rate of 15% (or, if ascertainable, the adjusted percentage for 1919)	1,125	
Net proceeds from sale	$6,375	
Cost of this material as adjusted at June 1, 1919, on the basis of 12c per yd.	6,000	
Gain on these transactions	$ 375	
Further, assume that the remaining 50,000 yards were unsold at the close of the taxable year 1919, and that the market price had risen to 17c per yd., the taxpayer would, in this case, have to readjust his inventory value to the 17c basis, and account for the element of appreciation, in this case (5c per yd. over adjusted figure as of June 1)	2,500	
Total gains		2,875
Adjusted loss upon which tax is to be abated or refunded, as the case may be		$ 4,500

notice and demand on Form 17.[78] Claims for refund to cover the loss in 1918 inventory, ascertained at the close of the taxable year 1919, should be filed within a reasonable time. There is, however, no time limit fixed by law within which such claims must be filed (except the general statute of limitations applying to all claims for refund) and therefore, the statement emanating from the Advisory Board that such claims should be filed within thirty days after the close of the taxable year 1919, must be considered as directory and not mandatory. Each claim must contain a concise statement of the amount of the loss sustained and the basis upon which it has been computed, together with all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim. The amount allowed by the Commissioner in respect of any such claim will be deducted from the net income for the taxable year 1918 and the taxes will be recomputed accordingly. Any excess paid over the tax due will be credited or refunded to the taxpayer. In computing income for the taxable year 1919 the opening inventory must be properly adjusted by the taxpayer in respect of any claim allowed for the year 1918.[79] Two claims may be filed, one at time of filing the return, and one adjusting the entire claim for losses at the close of the taxable year 1919. The first would represent a claim in abatement; the second, a claim for refund. It is possible that an additional amount of tax may become due from the taxpayer with interest at the rate of 1% per month from the time of making the deduction until the time of filing the final statement, which would be brought about by the fact that, in the disposition of unsold goods as to the 1918 inventory after the filing of the original return, and the claim in abatement, gains may result from subsequent sales. It will therefore be necessary for the taxpayer to prepare a statement which will

[78] Letter from Treasury Department dated August 6, 1919; I. T. S. 1919, ¶ 3537.

[79] Reg. 45, Art. 266. While the law and the regulations state that claims in abatement should be filed when the return for the taxable year of 1918 is made, the Treasury Department has ruled that taxpayers may file a claim for abatement based on revaluation of inventories at the time of filing return, or any time thereafter during 1919. This does not preclude the taxpayer from filing an amended claim during 1919, but after one claim has been allowed, no further claim may be made. (Telegram from Treasury Department dated April 3, 1919; I. T. S. 1919, ¶ 3291.)

fully reflect the corrected amount of any claim to which he may be entitled for losses in inventory of 1918, and this statement must definitely embrace the total amount of inventory value as recorded on the books of the taxpayer at the end of the taxable year 1918, and be capable of proper audit.[80] Taxpayers are required to file with the original claim and at the close of the taxable year 1919 summarized statements covering all adjustments involved. To conform to good accounting practices, the taxpayer should consider these summaries in the light of controlling accounts and the sum totals thereof should equal the total inventories maintained in detail by the taxpayer. Claims for losses in inventories of the taxable year 1918 should embrace all items in the taxpayer's inventory so that gains made in any sales of certain items or classes will be used to offset losses in others and the net result as to the entire inventory determined. Thus if the final computation shows a net gain over all inventory

[80] I. T. S. 1919, ¶ 3362. The following is an illustration of an outline to be used in making final statement of adjustment at the close of the taxable year 1919. This is based upon the illustration given above which applies to one item of inventory only, but it must be understood that the final statement referred to herein, must cover the entire inventory value as at the end of the taxable year 1918.

	Quantity	Value
1. Inventory close of taxable year 1918	200,000	$30,000
2. Sales from 1918 inventory during taxable year 1919	150,000	20,000
3. Less deductions from sales for selling expenses		3,000
4. Net sales proceeds (Item 2 value less Item 3)		17,000
5. Balance of 1918 inventory on hand at close of taxable year (Quantity Item 1 less Item 2) (Value priced at market close taxable year 1919)	50,000	8,500
6. Net sales proceeds and balance of inventory (Item 4 plus Item 5, values)		25,500
7. Loss (Item 1 value less Item 6)		4,500
8. Gain		......
9. Amount of claim in abatement or for refund filed		$ 7,375

In this illustration an excessive claim in abatement of tax based upon a loss of inventory values, amounting to $2,875 is assumed. Tax upon this amount with interest at one per cent per month between the date of making the deduction and final statement will be assessed in this case. Should the taxpayer elect not to file a claim in abatement at the time of filing his return, but rather to wait until the end of the taxable year 1919, then, in that case, but one claim would be filed.

items sold, no claim for loss in any particular item or items can be sustained.[81]

Claims of Partnerships. A claim in abatement arising from a loss in 1918 partnership inventory must be made by each individual partner as to his distributive share of recomputed net income. To this claim should be attached the statement of the partnership showing the loss in inventory supported in the same manner as such claims are supported by corporations and individuals. The statement filed as to the partnership as a whole will be used by the Department for the purposes of record and verification and any adjustments which may be found necessary will be spread pro-rata over the claims of the individuals. At the close of the taxable year 1919 a properly authorized member of the partnership must compile the final statement of adjustment in accordance with the methods previously outlined, attaching thereto the proportionate amounts of adjustment affecting each individual member of the partnership. On the determination of the net result, each individual partner should file a claim for refund (if any refund is due), or in the event that the claim in abatement was in excess of the actual losses sustained, each individual will remit to the collector of his district, his share of the additional amount of tax ascertained from the adjusted statement, with interest at the rate of 1% per month from the original due dates of the tax.[82]

Disposition of Claims. A claim for loss resulting from rebates paid or from actual sales can be decided as soon as practicable after it has been filed. A claim for loss in inventory not realized by sale can be decided only after the close of the taxable year 1919 upon the basis of any permanent reduction in the level of market values which have occurred during such year from the inventory values taken at the close of the taxable year 1918. Not later than thirty days after the close of the taxable year 1919 a taxpayer who has filed either a claim in abatement or a claim for refund, or both, must submit to the Commissioner a descriptive statement showing the quantity and kind of all goods included in the 1918 inventory which have been (a) sold

81 I. T. S. 1919, ¶ 3966.
82 I. T. S. 1919, ¶ 3370.

at a loss in the taxable year 1919, (b) sold at a profit during the taxable year 1919, or (c) not sold or otherwise disposed of during the taxable year 1919, together with such other information in respect of such goods as the Commissioner may require. A claim filed with the return for a loss not then realized by sale will be passed upon in the light of any sales thereafter made during the taxable year 1919. A claim filed with the return is authorized for the purpose of allowing the taxpayer to utilize, where justified, a preliminary allowance for inventory losses and not to provide a deduction essentially different from that taken by way of a claim filed at the end of the taxable year 1919.[83]

EFFECT OF CLAIM IN ABATEMENT. In the case of a claim in abatement filed with a return, payment of the amount of the tax covered thereby will not be required until the claim is decided, provided the taxpayer files therewith a bond on form 1124 in double the amount of the tax covered by the claim, conditioned for the payment of any part of such tax found to be due with interest at the rate of 12 per cent per annum. The bond must be executed by a surety company holding a certificate of authority from the Secretary as an acceptable surety on federal bonds and will be subject to the approval of the Commissioner. If abatement of any part of the tax covered by such a claim is denied, then such part must be paid by the taxpayer with interest at the rate of 12 per cent per annum from the original due date of the tax.[84]

LIBERTY OR OTHER BONDS AS SECURITY. In case the claimant, in accordance with the provisions contained in the Revenue Act of 1918,[85] elected to offer, in lieu of the surety or sureties provided for on Form 1124, United States Liberty Bonds or other bonds of the United States as security he could execute in duplicate a bond and agreement on Form 1124a. The original was to accompany the United States bonds offered as security; the duplicate was to be forwarded by the collector with the abatement claim to the Commissioner. If such bond and agreement was executed by a corporation a duly certified copy of the resolution of the board of directors, authorizing the execution, was also required. The United States Liberty Bonds or other bonds of

83 Reg. 45, Art. 267.
84 Reg. 45, Art. 268.
85 Revenue Act of 1918, §1320.

the United States, offered as security, had to be, in par value, not less than the amount of the penal sum of the bond executed on Form 1124a, which had to be in double the amount of the tax covered by the abatement claim. The bonds so offered as security were delivered to the Commissioner at the obligor's risk and expense. Registered bonds so offered as security were registered in the name of the obligor and duly assigned to the Commissioner at or before the date of deposit with the Commissioner. The Commissioner issued a receipt in duplicate for United States Bonds so deposited with him as security, the original of the receipt being given to the obligor, and the duplicate retained by the Commissioner for his files. Bonds of the United States will be returned to the obligor as soon as the security for the performance of such penal bond is no longer necessary. Registered bonds will be reassigned to the owner when the liability is cancelled.[86]

[86] T. D. 2925.

CHAPTER 26

DEDUCTION OF ALLOWANCE FOR DEPRECIATION, OBSOLESCENCE AND AMORTIZATION

In the case of individuals the Revenue Act of 1918 permits a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business of an individual, including a reasonable allowance for obsolescence.[1] In the case of non-resident aliens, the deduction for depreciation or obsolescence is permitted if and to the extent that it is connected with income arising from a source within the United States; and the proper apportionment and allocation of the deduction with respect to sources of income within and without the United States is determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[2] In the case of corporations, the allowance is also for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence,[3] limited in the case of a foreign corporation as above indicated in the case of non-resident aliens.[4] It must be borne in mind that the allowance for depreciation or obsolescence does not include any element of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property, its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date.[5]

1 Revenue Act of 1918, § 214 (a) 8.
2 Revenue Act of 1918, § 214 (b).
3 Revenue Act of 1918, § 234 (a) 7.
4 Revenue Act of 1918, § 234 (b).
5 Reg. 45, Art. 161.

The new provisions of the Revenue Act of 1918 for the deduction of a reasonable allowance for obsolescence and amortization are treated in this chapter in addition to the subject of depreciation of property used in the trade or business of a taxpayer. Depreciation in the case of farmers is discussed elsewhere in this book.[6]

Depreciation Under Preceding Income Tax Laws. The 1909 Law[7] allowed the deduction of all losses including a reasonable allowance for depreciation of property, if any. The 1913 Law allowed as a deduction in the case of individuals[8] "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business," and in the case of corporations[9] all losses "including a reasonable allowance for depreciation by use, wear and tear of property, if any." The 1916 Law allowed to individuals[10] a deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade," and to corporations[11] a deduction of all losses "including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." It is important to note the difference in phraseology between these various provisions in consulting any case decided under preceding laws as an authority under the present law.

Depreciable Property. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art or to becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade; nor to land apart from the improvements or

6 See Chapter 7.
7 Act of August 5, 1909, § 38.
8 Act of October 3, 1913, § B.
9 Act of October 3, 1913, § G (b).
10 Revenue Act of 1916, §§ 5 (a), 6 (a).
11 Revenue Act of 1916, § 12.

physical development added to it.[12] It does not apply to bodies of minerals which through the process of removal suffer depletion, other provision for this being made in the statute by way of an allowance for depletion.[13] Property kept in repair may, nevertheless, be the subject of a depreciation allowance.[14] The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, a building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business,[15] may be the subject of a depreciation allowance.[16]

Loss in Rental Value of Buildings. Under the former laws the deduction on account of depreciation could not include any allowance for an estimated loss due to lessening of rental value, nor could the computation of the deduction be influenced by the changed environment after a period of years, nor by its lack of adaptability to the use originally intended, nor to any other outside influence affecting its value. But under the present law it would seem that these factors of obsolescence may be given weight in calculating the depreciation of office buildings, apartment houses and other structures. However, the regulations appear still to hold to the old rule.[17]

Real Estate. Real estate, as such, and as distinct from the improvements thereon, is not reduced in value by reason of wear and tear and an allowance for depreciation in the case of real estate does not apply to the ground. The allowance is intended to measure the decline in the value of the improvements due to the wear and tear thereof.[18] In determining the cost of real estate upon which depreciable property is located, it frequently occurs that no segregation is made of the cost of buildings as

12 See paragraph on real estate, below.

13 See Chapter 28.

14 See p. 408.

15 See p. 404.

16 Reg. 45, Art. 162; Reg. 33 Rev., Art. 159; T. D. 2153; T. D. 2005. Depreciation as an allowable deduction in ascertaining net income for the purpose of the income tax is not to be confused with the deduction for loss.

17 Cohen v. Lowe, 234 Fed. 474; Reg. 33 Rev., Art. 162; Reg. 45, Art. 166.

18 Reg. 45, Art. 162; Reg. 33 Rev., Art. 162; T. D. 2152; T. D. 2137.

separate and distinct from the cost of the ground upon which such buildings stand. In such cases where the actual cost of the buildings or improvements at the time they were taken over by the taxpayer can not be definitely determined, it will be sufficient, for the purpose of determining the rate of depreciation to be used in computing the amount deductible from gross income, to estimate the actual value at the time acquired, of buildings or improvements if acquired after March 1, 1913, or the fair market price or value as of that date, if the property was acquired prior to March 1, 1913.[19]

WEARING APPAREL. If costumes purchased by actors and actresses are used exclusively in the production of a play and are not adapted for occasional personal use, and are not so used, deduction may be claimed on account of such depreciation in their value as occurs during the year on account of wear and tear arising from their use in the production of a play, or a loss may be claimed if they become obsolete at the close of the production.[20]

MERCHANDISE. Depreciation does not apply to inventories or to stock in trade.[21]

Intangible Property. Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation

19 Reg. 33 Rev., Art. 163; T. D. 2137; T. D. 2152.

20 Reg. 45, Art. 162; Reg. 33 Rev., Art. 8; T. D. 2090. See Reg. 45, Art. 143, if loss is claimed.

21 Reg. 45, Art. 162. It has been held under previous laws that depreciation computed on total invoice cost of merchandise in stock is not an allowable deduction, except that if any portion of the merchandise in stock is unsalable by reason of obsolescence or damage, a depreciation deduction not in excess of the decline in value during the taxable year will be allowed. (Reg. 33 Rev., Art. 169.)

allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner.[22]

DEPRECIATION ALLOWANCE FOR PATENT OR COPYRIGHT. In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorney's fees, etc., actually paid. If a corporation purchased a patent and paid for it in stock or securities, its cost is the fair market value of the stock or securities at the time of the purchase. Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the obsolescence occurred in the year for which the return is made is submitted to the Commissioner. The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.[23]

DEPRECIATION OF DRAWINGS AND MODELS. A taxpayer who has incurred expenses in his business for designs, drawings, patterns,

[22] Reg. 45, Art. 163; T. D. 2929; Reg. 33 Rev., Art. 162; T. D. 2152; T. D. 2137.

[23] Reg. 45, Art. 167.

models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction may be made against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof.[24]

Capital Sum Returnable Through Depreciation Allowances. The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date.[25] In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date.[26] To this sum should be added from time to time the cost of improvements, additions, and betterments,[27] the cost of which is not deducted as an expense in the taxpayer's return, and from this sum should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from that gradual exhaustion of its utility which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for example, land and buildings, the capital sum to be

24 Reg. 45, Art. 168.

25 It was held in early rulings that depreciation could only be claimed on the basis of cost whether or not the property was acquired prior to March 1, 1913 (T. D. 2446), but a later ruling recognized the principle of claiming depreciation on the value as of March 1, 1913, if the property was acquired prior thereto (T. D. 2754, August 23, 1918).

26 T. D. 2754.

27 As to incidental repairs see below.

replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition.[28]

Method of Computing Depreciation Allowance. The capital sum to be replaced by the depreciation allowance should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice,[29] such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return.[30] If it develops that the useful life of the property has been underestimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of buildings due to deterioration of the neighborhood, or, on the other, appreciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimate of the useful life of the property.[31]

Annual Allowances Measured by Life of Property. The annual allowance may be determined by dividing the cost by the probable number of years constituting the life of the property, the result being the amount which may be deducted annually. The life of the property necessarily depends upon its character, the use to which it is put and the conditions under which it is used. These elements being taken into consideration, taxpayers are expected, as a result of experience and observation, to approximate very closely the number of years constituting the life of

28 Reg. 45, Art. 164.

29 Claiming depreciation in accordance with any practice other than that of dividing the cost by the useful life of the property is first recognized in this ruling.

30 Reg. 45, Art. 165.

31 Reg. 45, Art. 166; Reg. 33 Rev., Art. 165.

the property.[32] If, after property has been used for a certain purpose, it is put to another use by which it deteriorates more rapidly the allowance for depreciation may be increased accordingly. In estimating the life of the property it is assumed that the owner will make such repairs and renewals as are necessary to prevent undue deterioration. In the case of a building, for instance, depreciation is to be based upon the life of the building with regard to the number of years the building will remain in a condition to be useful for the purpose for which it was constructed and is used, not merely the number of years it will stand without being condemned and torn down. In determining the life of the building it is assumed that the owner will keep it in good repair.[33]

INCIDENTAL REPAIRS TO PROPERTY ON WHICH DEPRECIATION IS CLAIMED. Depreciation is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to exhaustion, wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs.[34] Ordinary incidental repairs which keep the property in an operating condition should not be charged to depreciation reserve; their cost should be charged to expense. A building or a piece of machinery or other equipment, as a whole, may deteriorate in value and usefulness by reason of wear and tear regardless of the fact that certain minor component parts may be renewed, restored or replaced. The depreciation deduction contemplates the creation of a fund that will renew, restore or replace the original property, when it has become worn out or exhausted, regardless of the renewal and restoration of parts that may have been made in the meantime. Hence, in addition to the depreciation deduction, the expense of incidental repairs which do not add to the value of the property, but merely keep it in operating condition, and arrest deterioration, should be deducted as expense in the year in which the repairs are made.[35]

32 T. D. 2152.

33 Cohen v. Lowe, 234 Fed. 474.

34 San Francisco Co. v. Scott, 253 Fed. 854.

35 Reg. 45, Art. 103. Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33 Rev., Art. 131.

RENEWALS TO PROPERTY. It is possible in some instances that worn out parts of a machine or similar equipment may be renewed, one after another, until the original machine or equipment is swallowed up in the renewed parts. The machine or equipment is then in as good operating condition as it was originally. In such cases, if the cost of renewed parts is charged to operating expense, no deduction on account of depreciation should be claimed as to such machine or equipment. And on the other hand, if a reserve is set up to cover property which may be renewed or restored part by part until the whole is renewed, the cost of the renewed part should be charged to the depreciation reserve fund and not to expense.[36]

ADDITIONS AND BETTERMENTS. Amounts expended in additions and betterments or for furniture and fixtures which constitute an increase in capital investment and add to the value of the assets are not a proper deduction as expense, but such expenditures when capitalized may be extinguished through annual depreciation deductions, which latter deductions will be computed upon the basis of the cost and probable life of the property.[37]

Rate of Depreciation. The annual allowance for depreciation, is required by law to be "reasonable." No fixed rates are prescribed. The rule which has been established contemplates that the taxpayer may determine his annual deduction by dividing the cost of the property or the fair market price or value as of March 1, 1913, if acquired prior thereto, by the probable number of years constituting its life, in the manner indicated above, the result being the amount which may be deducted annually.[38] De-

[36] Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

[37] Reg. 45, Art. 164; Reg. 33 Rev., Art. 132.

[38] Reg. 45, Art. 161; Reg. 33 Rev., Art. 162; T. D. 2152. A collector who told taxpayers in his district that the amount of depreciation on frame buildings was limited to 3%, and in case of brick buildings to 2%, was informed by the Commissioner that while these rates might not be far from a reasonable and fair measure of depreciation sustained on such buildings, the rates should not be considered as the "limit," as the probable number of years constituting the life of the building might make the rate more or less than the figures stated. (Letter from Treasury Department dated May 22, 1916; I. T. S. 1918, ¶ 1496.) It has been held in the case of a telephone company that the average life of the combined elements which make up the plant is about 14 years and that the rate of depreciation properly chargeable against the value of the plant as a whole is 7%. (Cumberland Tel. & Tel. Co. v. Louisville, 187 Fed. 637, 654.)

preciation may also be claimed in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production.[39]

DEPRECIATION OF APARTMENT HOUSES. In the case of an apartment house the court has held that where the Government allowed 3% of the cost as annual depreciation, the burden was on the owner to show that this amount was too small, the court considering the rate to be reasonable in this case.[40]

DEPRECIATION OF STEAMERS. In a case involving the depreciation of a steamer, it has been conceded that 5% of the book value thereof, which would contemplate a life of 20 years, was a reasonable deduction.[41] In the case of some ships constructed during the war there seems to be a tendency to allow even a greater rate of depreciation on the theory that the useful life will be less than twenty years.

FACTORIES RUNNING NIGHT SHIFTS. When machinery and equipment are operated more than the usual number of working hours, a greater rate of depreciation may be applied in determining the annual exhaustion, wear and tear sustained than would be permitted in the case of machinery normally operated only eight or nine hours a day. No definite rulings have been made as to the amount by which depreciation may be increased on this account. Each case is considered in connection with all the facts and figures relative thereto.[42]

Annual Allowance Must Be Charged Off on Books. A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet. A journal entry alone is not sufficient.[43] The allowances should be computed and

39 Reg. 45, Art. 165. See note 29.

40 Cohen v. Lowe, 234 Fed. 474. See pp. 403, 413.

41 San Francisco Co. v. Scott, 253 Fed. 854.

42 Letter from Treasury Department dated July 12, 1918; I. T. S. 1919, ¶ 2148.

43 Letter from Treasury Department dated May 18, 1916; I. T. S. 1918, ¶ 1591.

charged off with express reference to specific items, units or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for each year for each item, unit or group.[44] This charging off of the depreciation allowance is required in order to insure that the returns of the taxpayer are in accord with his books of account and in order that error and fraud with respect to the facts may be prevented. The statute is not, however, to be considered as requiring that depreciation, depletion and other losses be charged off within the taxable year. It is sufficient that they are charged off before they are allowed as deductions. Consequently the taxpayer may at any time reopen his books and charge off depreciation which he actually sustained during the taxable year. If the books are reopened for this purpose, corresponding corrections must be made in the other book entries and if for any reason the facts do not warrant such other charges it will be held that the depreciation cannot be charged off and therefore cannot be allowed as a deduction. For exam-

[44] Reg. 45, Art. 169; letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33, Art. 130; Reg. 33 Rev., Art. 159; letter from Treasury Department dated February 12, 1915; I. T. S. 1918, ¶ 1526. Neither the 1909 Law nor the 1913 Law required that in order to secure a deduction for depreciation the amount claimed should be written off. It was, nevertheless, held by the Treasury Department that a depreciation deduction, in order to be allowable must be so entered upon the books of a corporation as to constitute a liability against its assets. (Letter to Collectors dated August 27, 1914; I. T. S. 1918, ¶ 1483.) In a later ruling it was held that, under these acts the writing off of depreciation would not be insisted upon in the adjustment of returns filed for the years 1909 to 1915 inclusive. (T. D. 2481, dated April 10, 1917.) In the meantime the courts had held, under the 1909 Law, that the contention that no allowance for depreciation could be claimed unless entered on the books of the company, recorded from time to time, was without force (U. S. v. Nipissing Mines Co., 202 Fed. 803 reversed in part on jurisdictional grounds, 206 Fed. 431) and that the fact that a deduction was incorrectly carried on the books in surplus account did not justify the Government in disallowing it. (Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704.) The Supreme Court of the United States declined, in Strattons' Independence v. Howbert, (231 U. S. 399) to answer the question as to whether or not a book entry was necessary, since the question was not properly brought before the court in that case.

ple, if by reason of a distribution of earnings there is nothing from which to credit a reserve for depreciation no allowance for depreciation can be credited to a depreciation reserve account.[45]

Reserves for Depreciation. In early rulings it was held that depreciation set up on the books and deducted from gross income could not be used for any purpose other than making good the loss sustained by reason of the wear and tear or exhaustion of the property; and that if any portion of the depreciation set up was diverted to any purpose other than making good the loss sustained by reason of such depreciation the amount would be disallowed. It was also held that the investment of depreciation reserve funds in additions, betterments and improvements was not contemplated by the law.[46] The present ruling holds that the allowance for depreciation is to be credited to an appropriate reserve account and be carried as a liability against the assets, to the end that when the total of these credits equals the capital investment account no further deductions will be allowed. There is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed, or in restoring the capital investment in the depleted assets. The depreciation reserve may be invested in assets of any kind.[47]

45 Letter from Treasury Department dated June 25, 1919; I. T. S. 1918, ¶ 2115. The 1916 Law did not expressly require individuals to enter on their books the annual allowance for depreciation but with respect to domestic corporations it expressly provided that all losses, including the allowance for depreciation, must be "charged off" within the year. Revenue Act of 1916, §§ 5 (a), 6 (a), 12 (a), 12 (b). As to foreign corporations the law was silent.

46 Reg. 33, Arts. 132 and 133; T. D. 2137.

47 T. D. 2481. It was stated in Revised Regulations No. 33 as follows: "Depreciation set up on the books and deducted from gross income can not be used for any purposes other than in making good the loss sustained by reason of the wear and tear of the property with respect to which it is claimed. If, however, an investment is made in extensions, additions, or betterments of the company's own property, representing a part or the whole of the credit balance of the depreciation reserve account, such investment will not be considered a misuse or diversion of the depreciation deduction otherwise allowable." (Reg. 33 Rev., Art. 164.) The language used in the text above seems, however, to be a sounder statement of the law.

Closing Depreciation Account as to Any Item. If the use of any property in the business is permanently discontinued, although no sale or other disposition of the property has taken place, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received should be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference should be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition took place.[48]

Obsolescence. The Revenue Act of 1918 provides that the deduction permitted to individuals or corporations for the exhaustion, wear and tear of property used in trade or business, may include "a reasonable allowance for *obsolescence*." Obsolescence is that loss which occurs in respect of tangible property from the changes due to the normal progress of the art in which such property may be used, or to becoming inadequate to the growing needs of the business.[49] This definition, however, seems to be incomplete and does not take into consideration classes of property such as buildings, which may become obsolete for the purposes for which they were erected. A taxpayer who in computing depreciation allowances in returns for years prior to 1918 has not taken ordinary obsolescence into consideration may, for the year 1918 and subsequent years, revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art or the growing needs of the business.[50]

OBSOLESCENCE UNDER 1916 LAW. The position taken by the Treasury Department under the 1916 Law was that obsolescence was not contemplated by the provision of the law relating to depreciation, and that no other provision of the law permitted an annual allowance with respect thereto, since neither the time

48 Reg. 45, Art. 170.

49 See Chapter 25 for a discussion of "Loss of Useful Value."

50 Revenue Act of 1918, §§ 214 (a) 8, 234 (a) 9; Reg. 45, Arts. 162, 166.

when property may become obsolete nor the loss when the stage of obsolescence is reached, can be determined in advance with any degree of certainty.[51] The deduction for depreciation was limited to the creation of a reserve fund, out of which the loss due to use, wear, and tear might be compensated. It was not considered possible to determine in advance when a piece of machinery, equipment or even a building would become obsolete and the Treasury Department held that since obsolescence could not be anticipated, an annual deduction would not be permitted to provide therefor.[52] Losses on account of obsolescence of physical property were permitted under the 1916 Law however as a deduction under the heading of loss, provided their amount had been recorded in the books following the condemnation and withdrawal from use of the obsolete property. The amount of obsolescence was ascertained by deducting from the cost of the property the sum of (a) the total amount that had been previously deducted on account of the depreciation of the property, and (b) its residuary value at the time of obsolescence, or (c) the amount received from the sale of the property. The obsolescence deduction could not include the accumulated depreciation applicable to prior years.[53] If no depreciation had been charged off on account of the property in respect of which obsolescence was claimed from the gross income of prior years, the amount allowable as a deduction for the year in which the property became obsolete was ascertained by deducting from the cost of the property the sum of (a) its residuary value and (b) an amount equal to the depreciation actually sustained during the prior period, which might have been deducted when computed at the rate applicable to the same or similar property. The

51 In earlier rulings, the Treasury Department held that depreciation applied to intangible property, subject to wear and tear, exhaustion or obsolescence (Reg. 33, Art. 129; T. D. 2005; T. D. 2077; T. D. 2090). In San Francisco Co. v. Scott, 253 Fed. 854, a case arising under the 1909 Law, which permitted the deduction of "losses * * * including a reasonable allowance for depreciation, if any," the court held that depreciation, as used in that Law, was intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay or gradual decline from natural causes, inadequacy, and "obsolescence."

52 Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

53 Reg. 33 Rev., Art. 178.

amount of depreciation thus arrived at, as applicable to former years, might be made the basis of amended returns, and a claim for a refund of taxes overpaid, by reason of the fact that no depreciation deduction was claimed in such years, might be made.[54]

Obsolescence in the Case of Distillers, Dealers in Liquor, etc. It was first ruled by the Treasury Department that a reasonable allowance for obsolescence of good-will, trade-marks and trade-brands, the value of which has been impaired or destroyed by prohibition legislation, might be taken by distillers and dealers in liquor against earnings between November 21, 1918, the date upon which the Agricultural Appropriation act, providing for war-time prohibition was enacted, and July 1, 1919, the date upon which war-time prohibition became effective. The latter date was subsequently changed to January 16, 1920, as stated below. To sustain a claim for a deduction for obsolescence in respect of good-will, trade marks, or trade brands, the taxpayer must show that the value of the property in question was destroyed not later than June 30, 1919, and that the taxpayer is not continuing in any similar trade or business. An allowance will be made only in respect of such assets as are assignable as distinguished from those attaching to the individuals owning or conducting the business or to the premises at which it is being or has been conducted. No allowance for obsolescence will be made in any case where, in connection with the operation of his previous business, the taxpayer has developed a good-will, trade-mark, or trade brand that is valuable in continuing a lawful business after June 30, 1919. The values will be based on those as at March 1, 1913, if the good-will, trade marks, or trade brands were acquired or established prior to that date, or at the actual cost thereof, if acquired subsequent to February 28, 1913. Information helpful in establishing the values would be of the following general character: A. Where the good-will, trade marks, or trade brands were acquired prior to March 1, 1913: (1) The nature of business (whether distillers, wholesalers, or retailers, or a combination thereof). (2) Date of foundation of business and whether organized as an individual, partnership, or corporation. Also date and particulars of each change in the ownership or form of organization of the business,

54 Reg. 33 Rev., Arts. 162 and 179.

such as the admission or retirement of a partner or partners; the incorporation of a company and of each reorganization thereof, (3) In respect to the trade marks or trade brands for which a deduction is claimed: (a) The date established and by whom. (b) The date of acquisition by the present owners. (c) The price paid therefor and whether paid in cash or stock; if the latter, state the basis of the valuation on which the purchase price was determined. (d) For each year from 1900 or the date of the establishment of the trade mark or trade brand, if subsequent to that year, to 1919 inclusive: (I) Annual sales (quantity and amount). (II) The gross profit on sales (i. e., the difference between the selling price and the cost price of the merchandise sold). (III) The total expenses and losses of the business which, when deducted from the gross profit on sales, will produce—(IV) The net income. Where the records permit, the sales and gross profit on sales should be submitted for each class of merchandise sold and, if possible, for each trade-mark or trade brand in respect of which a deduction is claimed. (V) The amount of capital invested in the business (i. e., capital or capital stock and paid in or earned surplus and undivided profits) as at the beginning of each year. (VI) The amount included in the invested capital at the beginning of the period in respect of good-will, trade-marks, or trade brands and the date and amount of each subsequent addition to the good-will, trade-marks, or trade brands. (e) Full details of each offer to purchase any of the trade-marks or trade brands, setting forth in particular the date of each offer, by whom and on whose behalf made: the amount of each offer, and whether payable in cash or stock; and the date or dates on which the purchase price was proposed to be paid, and the amounts to be paid on each such date. (4) Where a deduction is claimed in respect of good-will, as distinct from trade-marks or trade brands, the following information should be submitted: (a) The date of acquisition, and from whom acquired. (b) The amount paid therefor and whether paid in cash or in stock. If the latter, state the basis of the valuation on which the purchase price was arrived at. (c) For each year from 1900 or the date of acquisition, if subsequent to that year, to 1919, inclusive. (I) The annual sales of the business (quantity and amount) classified, if possible, as to the various kinds of merchandise sold. (II) Gross profit on each class of merchandise sold, or if the records do not disclose the informa-

tion, the gross profit of the business as a whole. (III) Total yearly expenses and losses of the business which, when deducted from the gross profit on sales, will produce—(IV) The net income from the business. (V) The amount of capital invested in the business (i. e., capital or capital stock and paid in or earned surplus and undivided profits), as at the beginning of each year. (VI) The amount included in invested capital at the beginning of the period in respect of good-will and the date and amount of each subsequent addition to good-will, trade-marks or trade brands. (d) Full details of each offer to purchase the good-will, setting forth in particular the date of each offer; by whom and in whose behalf made; the amount of each offer and whether payable in cash or in stock, and the date or dates on which the purchase price was proposed to be paid, and if on more than one date, the amount payable on each such date. B. Where good-will, trade-marks or trade brands were acquired subsequent to February 28, 1913: (1) Dates of acquisition of good-will or of each trade-mark or trade brand. (2) From whom acquired. (3) Purchase price of good-will or of each trade-mark or trade brand. (4) Whether purchased for cash or stock; if the latter, state the basis of the valuation on which the purchase price was arrived at. Similar information to that suggested in A—3d, and 3e, and in A—4 should also be furnished for each of the five years prior to the date of acquisition, and for each year thereafter up to and including the year 1919. C. In the case of good-will, trade-marks and trade brands acquired prior to March 1, 1913, a statement should be submitted showing the development of prohibition and local option laws within the territory of the taxpayer during the five years preceding March 1, 1913. Such statement should show each prohibition or local option law enacted by any State or other governmental unit within the business territory of the taxpayer, and should also state the unsuccessful efforts at such legislation during such period.[55] An extension of the period set forth above against the earnings of which the obsolescence might be taken as a deduction was later granted and the Treasury Department has now ruled that in arriving at the taxable income for the first taxable year ending on or after January 31, 1918, the obsolescence

[55] Letter from Treasury Department dated June 21, 1919; I. T. S. 1919, ¶ 3554.

fully accrued on that date is to be allowed as a deduction in computing the income subject to taxation under the Revenue Act of 1918, plus a further deduction of such proportion of the remaining value of the intangible assets as the interval between January 31, 1918, and the end of the taxable year bears to the total interval between January 31, 1918, and January 16, 1920, (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date will mark the close of the period), and that for any taxable year following the taxable year just referred to a deduction in respect of the value of such intangible assets on January 31, 1918, based upon a ratable distribution will be permissible. It is the opinion of the Treasury Department that the ratification of the 18th amendment in the month of January, 1918, by the States of Massachusetts, Maryland, and Kentucky, was the first definite indication that the prohibition amendment would be ratified by the requisite number of State Legislatures, and therefore that on January 31, 1918, a computable portion of the cost of good will, trade marks, trade brands, or the value thereof, on March 1, 1913, if acquired prior thereto (excluding any intangibles acquired since that date, the expenditures of which were deductible and had been deducted in computing income for tax purposes) had become obsolescent. On January 31, 1918, the intangible assets had an actual value, viz.: the then present value of the income to be derived therefrom between that date and January 16, 1920, or at an earlier date should the taxpayer discontinue his business prior thereto. This value as stated above should be distributed ratably over the period from January 31, 1918, to January 16, 1920 (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date will mark the close of the period). The excess of the cost of the intangibles or the value thereof, on March 1, 1913, if acquired prior thereto (subject to the exclusions mentioned above), over the value thereof, as of January 31, 1918, determined as outlined above, will represent the amount of obsolescence that was fully accrued on January 31, 1918.[56]

Amortization. The 1916 Law made no provision for amortization of plants or equipment acquired for Government contract

[56] Letter from Treasury Department dated August 19, 1919; I. T. S. 1919, ¶ 3561.

work. That law allowed the taxpayer only ordinary depreciation due to exhaustion, wear and tear, without considering the elements of amortization or obsolescence.[57] The Revenue Act of 1918, however, provides that, (a) in the case of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6th, 1917, for the production of articles contributing to the prosecution of the war with Germany, and (b) in the case of vessels constructed or acquired on or after April 6th, 1917, for the transportation of articles or men contributing to the prosecution of the war with Germany, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer. This allowance may not again include any amount otherwise allowed under the Revenue Act of 1918 or previous laws as a deduction in computing net income. At any time within three years after the termination of the recent war with Germany, as fixed by proclamation of the President, the Commissioner may, and at the request of the taxpayer must, re-examine the return and if he then finds, as a result of the appraisal or from other evidence, that the deduction originally allowed for amortization was incorrect, the income tax and war-profits and excess-profits taxes for the year or years affected, will be re-determined, and the amount of tax due upon such re-determination, if any, must be paid upon notice and demand by the collector. The amount of tax overpaid, if any, will be credited or refunded to the taxpayer.[58] Claims for amortization must be unmistakably differentiated in the return from all other claims for wear, tear, obsolescence, and loss. No such claim will be allowed unless it is reflected in any accounts submitted by the taxpayer to stockholders and in any credit statements by the taxpayer to banks, and is given full effect on his financial books of account. If Government or other contracts taken by the taxpayer contained recognition of amortization as an element in the cost of production, copies of such contracts must be filed with the taxpayer's return, together with a statement and description of any sums received on account of amortization and the basis upon which they were

[57] Letter from Treasury Department dated January 4, 1919; I. T. S. 1918, ¶ 3716. See p. 413 for a discussion of obsolescence under the 1916 Law.

[58] Revenue Act of 1918, §§ 214 (a) 9, 234 (a) 8.

determined. In any case in which an allowance has been made for amortization of cost, the taxpayer will not be allowed to restore to his invested capital for the purpose of the excess-profits tax any portion of the amount covered by such allowance.[59]

Scope of Provision for Amortization. Any allowance made to a taxpayer by a contracting Department of the Government or by any other contractor for amortization or fall in the value of property, either as a part of the cost of production or as a part of the price of the product, shall be included in gross income. The amount to be allowed as a deduction from gross income for amortization for the purpose of the tax is to be based upon the provisions of the statute and the regulations issued pursuant thereto. The deduction should be made upon this basis and not upon the basis of any amounts contractually or otherwise determined. The allowance for amortization covers the decline in value of the property subject thereto and is inclusive of the depreciation which would ordinarily be allowable separately. Depreciation for any taxable period after December 31, 1917, should, therefore, not be claimed with respect to property as to which an allowance for amortization is claimed.[60]

Property the Cost of Which May Be Amortized. The taxpayer may make a reasonable deduction from gross income not in excess of a sum sufficient to extinguish the cost of buildings, machinery, equipment, or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the recent war, and of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the recent war. In the case of property the construction or installation of which was commenced before April 6, 1917, and completed subsequently to that date, amortization will be allowed with respect only to the cost incurred on or after April 6, 1917.[61]

Cost Recoverable Through Amortization. The total amount to be extinguished by amortization, in general, is the excess of the unextinguished or unrecovered cost of the property over its maximum value (either for sale or for use as part of the plant

59 Reg. 45, Art. 186. For a definition of the term "government contract" see Reg. 45, Art. 1510.

60 Reg. 45, Art. 181.

61 Reg. 45, Art. 182.

or equipment of a going business) under stable postwar conditions. Under the provisions of the statute authorizing reexamination of the claim at any time within three years after the termination of the recent war, the allowance will be finally determined upon such basis. However, in many cases it was impracticable during the calendar year 1919 to make final determination either of the length of the amortization period or of the value of the property under stable postwar conditions. Consequently, in returns made during the calendar year 1919 the amortization allowance was tentatively determined in accordance with the rules contained in the next two paragraphs.[62]

COST WHICH MAY BE AMORTIZED. For the purpose of making returns in 1919 the total amount to be extinguished by amortization is the difference between the value of the property on the bases indicated below and the original cost of the property less any amounts otherwise deducted for depreciation, losses, etc., prior to January 1, 1918; or in the case of property acquired or completed after December 31, 1917, it is the difference between the value of the property on the bases indicated below and the cost of such property at the date of acquisition or completion. (1) In the case of property useful only during the war period and permanently discarded at the date of the return the basis is the salvage value as of the date when the property was discarded. (2) In the case of property still in use which will not be required for the future use of the business and which is certain to be permanently discarded before the last installment payment of the tax covered by the return the basis is the salvage value as of the date when the property will be permanently discarded. (3) In the case of other property the basis for amortization calculation will be the estimated value of the property to the taxpayer in terms of its actual use or employment in his going business, such value in no case to be less than the sale or salvage value of the property, provided, however, that in no case may the preliminary estimate (for purposes of returns to be made in 1919) of the amount of such merchandise exceed 25% of the cost of property. In the final determination the amount of the amortization allowance will be ascertained upon the basis of stable post war conditions under regulations to be promulgated when these conditions

[62] Reg. 45, Art. 183.

become apparent. A special record of all property falling in classes (1) and (2) must be preserved by the taxpayer and the Commissioner must be promptly advised (a) if such property is restored to use; (b) the selling price if sold; and (c), if still on hand and not in use at the close of the three-year period, the reasons why such property has not been disposed of.[63]

[63] Reg. 45, Art. 184 as amended by T. D. 2859. It is to be noted that the original ruling of the Treasury Department in this connection read as follows: "The total amount to be extinguished by amortization is the difference between the original cost to the taxpayer of the property and its value to the taxpayer at the close of the amortization period (a) for sale or (b) for use, immediate or prospective, as part of the plant or equipment of a going business, whichever value is the larger, less any amounts otherwise deducted or deductible for wear, tear, obsolescence and loss. In the case of property constructed or the installation of which was commenced before April 6, 1917, and completed subsequent to that date amortization will be allowed with respect only to the cost incurred on or after April 6, 1917." This ruling was then changed to correspond with the rule in the text foregoing, except that (3) read as follows: "In the case of other property the basis is the estimated reproduction cost as of April, 1919, of such property in its then condition. In the final determination such cost will be ascertained under stable postwar conditions, without reference to such date." The present regulation more justly carries out the intent of the statute to allow a deduction because of expenditures made during war time which would not have been made under peace conditions, for the reason that the normal business of the taxpayer would not have required increased facilities. Senator Simmons in discussing this provision in the Senate, February 11, 1919, said: "I can answer the Senator generally by saying that if by reason of the investment of his profits in an extension of his yards he has constructed a plant which was necessary in time of war to meet the demands which were made upon him at that time for production, but which after the termination of the war has depreciated in value because not needed; in that case, under the amortization provision he will be allowed to amortize to the full extent of the depreciation value. Of course, if there is salvage he would be allowed to amortize only down to the salvage value." (Congressional Record, February 17, 1919, p. 3774.) Under the rule established by the regulation last quoted "reproduction cost" as of April, 1919, which in most cases would exceed the cost of property to be amortized was taken as a temporary basis, final determination being postponed until "stable postwar conditions" arrived. In order therefore to have secured present relief by virtue of the amortization provision of the statute by extinguishing amortization by the difference between "salvage value" and original cost, the taxpayer must have permanently discarded property before December 15, 1919 (or the last installment date). The injustice of taking "salvage value" in one case and "reproduction cost" in another may be illustrated by the case of the taxpayer who had purchased two machines and discarded one of them, and another taxpayer who had purchased one machine

METHOD OF AMORTIZATION. For the purpose of making returns in 1919 the amount to be extinguished by amortization should be spread in proportion to the net income (computed without benefit of the amortization allowance) between January 1, 1918, and the following dates: (a) if the claim is based on subdivision (1) of the preceding paragraph, the date when the property was permanently discarded; (b) if the claim is based on subdivision (2) of the preceding paragraph, the date upon which the property will be permanently discarded; and (c) if the claim is based upon subdivision (3) of the preceding paragraph, April, 1919. All taxpayers claiming an allowance for amortization will be required to estimate the amount of their net income for the period between January 1, 1918, and the dates specified above, and also to estimate what part of such net income is properly allocable to the calendar year 1918 and what part thereof is properly allocable to the calendar year 1919. Such estimates shall be the basis for apportioning the amounts to be extinguished by amortization between the calendar years 1918 and 1919. Taxpayers reporting on the fiscal year basis (a) in all computations based upon 1918 rates should use the amount of such allowance apportioned to the calendar year 1918; (b) in any computation based upon 1919 rates for a year beginning in 1918 and ending in 1919 should use the amount of such allowance apportioned to the calendar year 1919; and (c) in any computation for a fiscal year beginning in 1919 should use as many twelfths of the allowance apportioned to the calendar year 1919 as there are months of such fiscal year falling in the calendar year 1919.[64] A claim for amortization applicable to the portion of the calendar year 1918 covered by the return of the taxpayer for the taxable year 1918 should be included in such return and if such amortization is not claimed therein it may not be taken in the return covering the taxable year 1919. The return for the taxable year 1919 should provide only for the proper amortization applicable to such taxable year ascertained in accordance with the above provisions.

of a capacity equivalent to the capacity of the two machines of the first taxpayer. Under the last quoted rule, the former would immediately obtain the benefit of the amortization provision and the latter would not have obtained it until the problematical time when "stable postwar conditions" return, if ever. This came close to being arbitrary discrimination.

64 Reg. 45, Art. 185.

However, in cases where it will be impracticable to determine accurately the amortization during the calendar year 1919, any returns made during such period should include amortization allowances tentatively determined in accordance with this and the preceding paragraphs. Returns made for the taxable year 1918, in cases where the taxpayers are entitled to amortization claims, should include such claims ascertained as above provided, and if subsequently the amortization as finally determined differs essentially from the amount claimed in the returns filed, then amended returns should be made.[65]

REDETERMINATION OF AMORTIZATION ALLOWANCE. Redetermination of the deduction allowed on account of amortization may, or at the request of the taxpayer must, be made by the Commissioner at any time within three years after the termination of the recent war, and if as a result of an appraisal or from other evidence it is found that the deduction originally allowed was incorrect, the amount of tax due for each taxable year during the amortization period will be adjusted by additional assessment or by refund.[66]

INFORMATION TO BE FURNISHED BY TAXPAYER. To obtain the benefit of this provision of the statute the taxpayer must establish to the satisfaction of the Commissioner that the entire deduction claimed and the proportion claimed for any particular year are reasonable. The taxpayer must also submit a supplementary statement setting forth the following information: (a) a description of the property in reasonable detail; (b) the date or dates on which the property was acquired, and from whom, or, if constructed, erected, or installed by the taxpayer, the dates on which such construction, erection, or installation was begun and completed; (c) evidence establishing the intention of the taxpayer cn and after April 6, 1917, or on and after the date of acquisition or the date of beginning construction, erection, or installation, to devote such property or vessels'to the production of articles (or, in the case of vessels, the transportation of articles or men) contributing to the prosecution of the recent war; (d) the cost of construction, erection, installation, or acquisition; (e) the value

65 Letter from Treasury Department dated June 9, 1919; I. T. S. 1919 ¶ 3391.

66 Reg. 45, Art. 187.

of the property after termination of the amortization period; (f) a segregation of the property permanently discarded, or of the property which will be permanently discarded before the last installment payment covered by the return; (g) all deductions from gross income otherwise taken or claimed with respect to such property; (h) the computation by which the total amount to be extinguished by amortization was determined; and (i) the computation by which the proportion of the amortization charge claimed as a deduction in the taxable year for which return is being made was determined.[67]

[67] Reg. 45, Art. 188.

CHAPTER 27

DEPLETION—IN GENERAL

The Revenue Act of 1918 contains a provision for the deduction of an allowance for depletion in the case of mines, oil wells, gas wells or any other natural deposits and timber.[1] The same allowance is permitted to individuals as to corporations and is permitted to non-resident aliens or foreign corporations with respect to property located in the United States. Depletion is the loss sustained through the progressive exhaustion of a mineral deposit or timber supply. Depletion allowances are made because mineral deposits and timber supplies are exhaustible and because each unit removed reduces the amount recoverable, and hence the value of the property. The 1916 Law provided for an allowance for depletion in the case of mines, oil and gas wells.[2] That law provided, in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, and in the case of mines a reasonable allowance not to exceed the market value in the mine of the product thereof which had been mined and sold during the year for which the return and computation were made. The present law does not limit the deduction for depletion in the same way but permits a reasonable allowance according to the peculiar conditions of each case. Both the 1916 Law and the 1918 Law permit the allowance for depletion to be based upon the value of the property as of March 1, 1913, or the cost, if the property has been acquired since that date. The 1916 Law made no reference to lessees and the Treasury Department ruled that a lessee could claim no depletion with respect to the value of the natural deposit on March 1, 1913.[3] The present law provides that in the case of leases the deduction shall be equitably apportioned between the lessor and the lessee. With respect to depletion the

1 Revenue Act of 1918, § 214 (a) and § 234 (a).

2 Revenue Act of 1916, § 5, § 6 and § 12.

3 The court, however, has held to the contrary. See Mohawk Mining Co. v. Weiss, U. S. Dist. Ct., N. D. of Ohio, I. T. S. 1919, ¶ 3635.

Treasury Department has ruled under the 1918 Law as stated in the following paragraphs.[4]

Depletion of Mines, Oil and Gas Wells. A reasonable deduction from gross income for the depletion of natural deposits and for the depreciation of improvements is permitted, based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within 30 days after the date of discovery in the case of mines, oil and gas wells discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The essence of this provision is that the owner of such property, whether it be a leasehold[5] or freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to the fair market value as of March 1, 1913, of the properties owned prior to that date, or an amount equal to the fair market value within thirty days after the date of discovery of mines, oil or gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the market value of the property is materially disproportionate to the cost; plus in any case the subsequent cost of plant and equipment (less salvage value), and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors, and lessees are entitled to deduct an allowance for depletion, but a stockholder in a mining or oil or gas corporation is not.[6]

Capital Recoverable Through Depletion Allowance in the Case of Owner. In the case of an operating owner in fee or a lessor

[4] This chapter gives only the general rules with respect to depletion. The special rules with respect to mines, oil and gas wells, and timber are given in the chapters following.

[5] Under the 1916 Law no allowance for depletion was permitted by the Treasury Department in the case of a lessee, but the lessee was permitted to claim "depreciation" on the actual bonus or other cost incurred in acquiring and developing property. The courts, however, have held that a deduction should be allowed to the lessee, under the 1916 Law. (Mohawk Mining Co. v. Weiss, U. S. Dist. Ct., N. D. of Ohio, I. T. S. 1919, ¶ 3635.)

[6] Reg. 45, Art. 201.

the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the property, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which has or should have been taken [7] to date, and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion.[8] The value of the surface of the land should be taken into consideration.[9] In no case, however, may a lessor include in his capital recoverable through such an allowance any part of development costs not borne by the lessor nor any part of the discovery value.[10]

Capital Recoverable Through Depletion Allowance in the Case of Lessee. In the case of a lessee the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the leasehold, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which has or should have been taken to date, and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion. Any annual or periodical rents or royalties supplementing the bonus or other amount paid for the lease may be charged to current operating expenses or, until the property reaches the operating stage, to capital account, and in the latter

[7] It is to be noted that the ruling contemplates that depletion must be taken consistently from year to year and more depletion than is allocated to the production of one year cannot be taken by reason of the fact that less has been deducted in a past year than could have been properly allocated to such past year.

[8] Depreciation should be claimed on all physical property "including rigs, tools, machinery, pipes, casing, and other equipment necessary to the operation of the wells or the field. The "physical property" as to which depreciation, as distinguished from depletion, should be claimed in the case of the oil and gas industry is enumerated elsewhere in this book. See p. 468. Depletion applies only to the loss due to exhaustion of the natural resource.

[9] That is, in the case of an owner the value of the surface of the land should not be considered as a part of the value of the natural deposit.

[10] Reg. 45, Art. 202.

event will form a part of the capital returnable through deductions for depletion.[11]

Apportionment of Deductions Between Lessor and Lessee. As the value of property comprehends the interests of both lessor and lessee, no computation, for the purpose of depletion allowances, of the value of these interests separately as of any date which combined exceeds the value of the property in fee simple will be permitted.[12] The same principle applies to holders of fractional interests. If the aggregate deduction claimed is deemed excessive, the Commissioner may request the owner or lessee to show that the valuation claimed does not exceed the fair market value of the property at a specified date determined in the manner explained below.[13] The lessor and lessee should, with the approval of the Commissioner, equitably apportion the allowance in the light of the peculiar conditions in each case and on the basis of their respective interests therein. To the return of every taxpayer claiming an allowance for depletion in respect of (a) property in which he owns a fractional interest only or (b) a leasehold or (c) property subject to a lease, there should be attached a statement setting forth the name and address and the precise nature of the holdings of each person interested in the property.[14]

Determination of Cost of Deposits. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral rights, or leasehold was acquired, the owner or lessee will be required upon request of the Commissioner to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner, in fact as well as in form, different from the vendor.[15] No fictitious or inflated cost or price will be permitted

11 Reg. 45, Art. 203.

12 This ruling means that the value of the property as of March 1, 1913, or the value as of thirty days after date of discovery must be apportioned between the lessor and lessee, but if, for instance, the lessee has paid a bonus in addition to royalties the lessee's depletion should in no case be less than the amount of the bonus regardless of what the value may have been on any particular date.

13 See p. 430.

14 Reg. 45, Art. 204.

15 That is, owners of a natural deposit will not be allowed to base depletion

to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof.[16]

Determination of Fair Market Value of Deposits. Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or in methods of mining or extraction. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. No rule or method of determining the fair market value of mineral property is prescribed, but the Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or state taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods, and other factors.[17]

Revaluations of Deposits Not Allowed. The cost of the property or its fair market value at a specified date, as the case may be, plus subsequent charges to capital account not deductible as current expense, will be the basis for determining the depletion and depreciation deductions for each year during the continuance of the ownership under which the fair market value or cost was fixed, and during such ownership there can be no revaluation for the purpose of this deduction. This rule will not forbid the redistribution of the capital account over the estimated number of

on a greater value by reason of incorporating or re-incorporating where the change of ownership is one of form and not substance.

[16] Reg. 45, Art. 205.

[17] Reg. 45, Art. 206.

units remaining in the property in accordance with either of the two rules set forth elsewhere in this book.[18]

Computation of Allowance for Depletion of Mines and Oil Wells. When the *cost* or *value* as of March 1, 1913, or within 30 days after the date of discovery of the property shall have been determined, and the *number of mineral units in the property* as of the date of acquisition or valuation shall have been estimated, the division of the former amount by the latter figure will give the *unit value* for purposes of depletion, and the depletion allowance for the taxable year may be computed by multiplying such unit value by the number of units of mineral extracted during the year. If, however, proper additions are made to the capital account represented by the original cost or value of the property, or unforeseen circumstances necessitate a revised estimate of the number of mineral units in the ground, a new unit value for purposes of depletion may be found by dividing the capital account at the end of the year, less deductions for depletion to the beginning of the taxable year which have or should have been taken, by the number of units in the ground at the beginning of the taxable year. This number, unless a revision of the original estimate has been necessary, will equal the number of units in the ground at the date of original acquisition or valuation less the number extracted prior to the taxable year. If, however, a recalculation is needed, the number of units at the beginning of the year will be the sum of the gross production of the year and the estimated mineral reserves in the property at the end of the year.[19]

Depletion and Depreciation Account on Books. Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property must keep accurate ledger accounts in which shall be charged the fair market value as of March 1, 1913, or within 30 days after the date of discovery, or the cost, as the case may be, (a) of the property, and (b) of the plant and equipment, together with such amounts expended for development of the property or additions to plant and equipment since that date as have not been deducted as expense in his returns. These accounts should be credited with the amount of the depreciation and depletion deduction claimed and allowed each year, or the amount of

18 Reg. 45, Art. 207. For the exceptions indicated in the text above, see pp. 436 and 448.

19 Reg. 45, Art. 210.

the depreciation and depletion should be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus the amount added thereto for the development or additional plant and equipment, less salvage value of the physical property, no further deduction for depletion and depreciation with respect to the property will be allowed. Because of the fact that depreciation and depletion deductions are applied against different capital sums, which are usually returnable at different rates, it is essential that these accounts be kept separately; that is, the cost or value of physical property subject to depreciaion with deductions for depreciation enter into one account, while the cost or value of the property (exclusive of physical property), together with additions for such development costs as have not been charged to current operating expenses or deducted as depletion, enter into a separate account. If dividends are paid out of a depletion or depreciation reserve, the stockholders must be expressly notified that the dividend is a return of capital and not an ordinary dividend out of profits.[20]

Rule Under the 1909 Law. The Act of August 5, 1909, did not provide for deductions from gross income on account of depletion of natural resources. The fact that revenues derived from operating mines resulted to some extent in exhaustion of the capital, established under that law no ground for the deduction from gross income of the value of the ore extracted.[21] Lessors could claim no deduction from royalties with respect to depletion.[22] Lessees were allowed to claim a deduction of a proportionate amount of the cost of the lease, but not of the value of the deposit at the incidence of the tax.[23] Although the Treasury Department prescribed rulings for determining depletion under the 1909 Law [24] such rulings were not authorized by the statute, and a corporation which had claimed depletion thereunder could not claim

20 Reg. 45, Art. 216; Manual of Oil and Gas Industry, p. 37. See Reg. 45, Art. 1549, for the rule with respect to dividends paid out of depletion reserves. (See p. 304.) It should be kept in mind that any dividend paid out will be deemed to be from earnings (and therefore taxable) unless the corporation has no surplus representing earnings accumulated since February 28, 1913.

21 Stratton's Independence Limited v. Howbert, 231 U. S. 339.

22 Sargeant Land Co. v. von Baumbach, 242 U. S. 503.

23 Biwabik Mining Co. v. U. S., 247 U. S. 116.

24 T. D. 1675.

that the Treasury Department was estopped by such regulations from assessing the tax without the benefit of any depletion under that law.[25]

Rule Under the 1913 Law. The 1913 Law allowed the taxpayer to deduct from the gross income of the taxable year on account of depletion of natural deposits an amount not to exceed 5% of the gross value of the output of the ore at the mine during the year.[26] The law did not require that the charge for depletion of natural deposits must actually be set up on the books of the taxpayer in order to constitute an allowable deduction. It was first held that such an entry must be made in order to obtain the benefit of the allowance,[27] but it was later held that failure to write off depletion would not result in a disallowance of the deduction.[28] It is now held that "An operating owner will determine the amount which he is entitled to deduct in his return as depletion by adding to the amount paid for the deposit or to its fair market value as of March 1, 1913, if acquired prior thereto, such costs of development since that date, as have not been deducted as expenses on his returns, and by dividing the resultant sum by the number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the years 1913, 1914 and 1915 the product of the per unit cost or value multiplied by the number of units produced within the year, provided such amount does not exceed 5 per cent of the gross value of the output for the year at the mine."[29] Under the 1913 Law and under the 1916 Law a lessor is permitted a depletion allowance which is computed like that of an operating owner, except that where a mine was leased before March 1, 1913, the allowance for depletion in favor of the lessor is based not on the fair market value of the ore or mineral in place as of March 1, 1913, but on the lessor's interest therein on that date.[30]

25 Goldfield Consolidated Mines Co. v. Scott, 247 U. S. 126.

26 Act of October 3, 1913, ¶ B and ¶ G.

27 Letter from Treasury Department dated May 18, 1916.

28 T. D. 2481.

29 Extract from circular entitled "Schedule for Depletion—1909-1917," issued by the Treasury Department, Mines and Minerals Section, 1919.

30 Id. But since the courts have held that a lessee acquires no interest in the mineral deposits in place, but only the privilege of entering upon the

Rule as to Mine Under the 1916 Law. Under the 1916 Law an operating owner is entitled to a reasonable allowance for depletion, limited in the case of mines to the market value in the mine of the product thereof mined and sold during the year, not exceeding in the aggregate the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date. In order that a taxpayer may have the benefit of the authorized deduction for depletion, the amount claimed must actually be charged off on his books before the allowance can be granted.[31] An operating owner will determine the amount which he is entitled to deduct as depletion by adding to the amount paid for the ore or mineral or to its fair market value as of March 1, 1913, if acquired prior thereto, such costs of development since that date as have not been deducted as expenses, and by dividing the resultant sum by the number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the year 1916 and subsequent years the product of the per unit cost or value multiplied by the number of units produced within the year. However, when the aggregate of such deductions shall equal the cost or fair market value as of March 1, 1913, plus the amount subsequently expended in developing the property which had not been deducted as an expense, the taxpayer will be entitled to no further deductions.[32]

premises and mining and removing such deposits, it would seem that the lessor's interest in a deposit as of March 1, 1913, was not, for the purpose of claiming depletion under the 1913 and 1916 Laws, diminished by reason of a lease existing on that date.

31 The amount need not however be written off in the taxable year. It is sufficient if the amount is charged off before being allowed as a deduction. Consequently at the time of an examination of a corporation it is allowed to reopen its books and charge off depletion actually sustained for any taxable year during which the 1916 Law was in effect. If, however, the facts do not warrant the opening of the books and charging off depletion for any past year, it will not be allowed as a deduction. Thus, for example, if all the earnings of a year have been distributed and there is nothing from which to credit a reserve for depletion no allowance for depletion can be credited to a reserve account or permitted as a deduction. (Letter from Treasury Department dated June 25, 1918; I. T. S. 1919, ¶ 2119.)

32 Extract from circular entitled "Schedule for Depletion—1909-1917," issued by the Treasury Department, Mines and Minerals Section, 1919.

Rule as to Lessees Under Prior Laws. As mining leases are held not to convey the mineral deposits in place, but only the privilege of entering upon the premises and mining and removing such deposits, under none of the acts of 1909, 1913, or 1916 is a lessee entitled to deduction from income on account of depletion. But under the provisions of the acts of 1909, 1913, and 1916, authorizing the deduction from gross income of the ordinary and necessary expenses of the business, including rentals, the lessee may deduct royalties paid as such necessary expenses, and in the event that he paid a lump sum for his lease, such sum may be considered as rent paid in advance and, together with the cost of development not deducted as expenses, may be divided by the estimated number of units in the mine as of the date of acquisition in order to determine the expense per unit for the purpose of deduction. The lessee is then entitled to deduct as expense the product of the per unit expense multiplied by the number of units produced within the year. If the lessee is unable to determine the proper amount based upon investment in accordance with the method outlined above, he may deduct in his return the pro rata portion of the amount expended for the lease and for development based upon the life of the lease.[33]

Depletion for Past Years Not Allowed Under Present Law. Where under the act of October 3, 1913, or of September 8, 1916, a taxpayer has not been allowed to make a deduction for the full amount of his depletion, the amount of such deficiency can not be carried forward and deducted in any later year. Depletion attaches to each unit of mineral or other property removed, and a taxpayer should make proper provision therefor in computing his net income. Under the Revenue Act of 1918 the amount recoverable through depletion will be the cost, or the value as of March 1, 1913, or within 30 days of the date of discovery, as the case may be, less proper allowance for the mineral or other property removed prior to January 1, 1918.[34]

33 Id. In Mohawk Mining Co. v. Weiss, U. S. Dist. Ct., No. D. of Ohio, I. T. S. 1919, ¶ 3635, the court held that the 1916 Law permitted the deduction *by a lessee* of an allowance for depletion.

34 Manual for the Oil and Gas Industry, p. 42.

CHAPTER 28

DEPLETION OF MINES

The provision of the Revenue Act of 1918 permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or any other natural deposits and timber, has been set forth and discussed generally in the preceding chapter. It is shown in that chapter that this allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within thirty days after the date of discovery in the case of mines discovered by the taxpayer after February 28, 1913, where the fair market value is seriously disproportionate to the cost. This allowance is permitted to operating owners, lessors and lessees, and the capital recoverable through the depletion allowance in the case of each and the rules with respect to the apportionment of the deduction between lessor and lessee are discussed in the same chapter.[1] In general, the allowance for depletion is ascertained by multiplying the number of mineral units extracted from a mine each year by the unit value. The unit value is ascertained by dividing cost, or value as of March 1, 1913, or within 30 days after discovery, by the number of mineral units in the property as of the date of acquisition or valuation.[2] The preceding chapter should be consulted for the rulings regarding depletion generally; certain special rules relating specifically to mines are set forth below.[3]

Determination of Quantity of Ore in Mine. Every taxpayer claiming a deduction for depletion will be required to estimate with respect to each separate property the total units (tons, pounds, ounces, or other units) of ores and minerals reasonably known or

1 Reg. 45, Art. 201.

2 Reg. 45, Art. 210.

3 Many of the rules stated in the next chapter with regard to the oil and gas industry have a general application and should be consulted for additional information.

on good evidence believed to have existed in the ground on March 1, 1913, or on the date of acquisition of the property, or within 30 days after the date of discovery, as the case may be. In estimating the total units of ores and minerals for purposes of depletion the property must be considered in the condition in which it was on March 1, 1913, or the date of acquisition, or within 30 days after the date of discovery, but if subsequently during the ownership of the taxpayer making the return additional recoverable mineral deposits have been discovered or developed which were not taken into account in estimating the number of units for purposes of depletion, or if it shall be discovered by working, development, or exploration that ground previously estimated to contain commercially recoverable mineral is barren or contains only commercially unworkable mineral, a new estimate of the recoverable units of ores or minerals (but not of the cost or fair market value at a specified date) must be made and when made shall thereafter constitute a basis for depletion. In the selection of the unit of estimate the custom or practice applicable to the type of mineral deposit and the character of the operations thereon should be considered. The estimate of the recoverable units of ores or minerals for the purpose of depletion should include (a) the ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms in respect to the type of deposit, and may also include (b) "prospective" or "probable" ores and minerals (in the same sense), i. e., ores and minerals that are believed to exist on the basis of good evidence, although not actually known to occur on the basis of existing development, but "probable" or "prospective" ores and minerals may be computed for purposes of depletion only as extensions of known deposits into undeveloped ground.[4]

Depletion of Mine Based on Advance Royalties. Where the owner has leased a mining property for a term of years with a requirement in the lease that the lessee shall mine and pay for annually a specified number of tons or other agreed units of measurement of such mineral, or shall pay annually a specified sum of money which shall be applied in payment of the purchase price or agreed royalty per unit of such mineral whenever the same shall thereafter be mined and removed from the leased

[4] Reg. 45, Art. 208.

premises, the value in the ground to the lessor for purposes of depletion of the number of units so paid for in advance of mining will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor may be claimed or allowed in any subsequent year on account of the mining or removal in such year of any ore or mineral so paid for in advance and for which deduction has been once made. If for any reason any such mining lease shall be terminated before the ore or mineral therein which has been paid for in advance has been mined and removed, and the lessor repossesses the leased property, an amount equal to the aggregate deductions for depletion allowed in respect of ore or mineral not mined and removed by the lessee, but still in the ground, will be deemed income to the lessor and will be returned as such for the year in which the property is repossessed.[5]

Statement to Be Attached to Return Where Depletion of Mine Claimed. To the return of the taxpayer claiming a deduction for depletion or depreciation or both there should be attached a statement setting out: (a) whether the owner is a fee owner or lessor or both; (b) a description of the property owned in fee, if any, and a description of the leasehold property, if any, including the date of acquisition and the date of expiration of the lease; (c) the fair market value as of March 1, 1913, or within 30 days of the date of discovery, or the cost, as the case may be, of the property owned in fee and the leasehold property, together with a statement of the precise method by which the value or the cost of freehold and leasehold property was determined; (d) the estimated number of units of mineral or ore at the date of acquisition or of valuation in the property owned in fee and in the leasehold property separately, together with an explanation of the method used in estimating in each case the number of units of mineral or ore for purposes of depletion; (e) the amount of capital applicable to each unit; (f) the number of units removed and sold during the year for which the return was made; (g) the total amount deducted on account of depletion and on account of depreciation, stated separately, up to the taxable year during the ownership of the taxpayer; and (h) any other data which would be helpful in

5 Reg. 45, Art. 215.

determining the reasonableness of the depletion and depreciation deductions claimed in the return.[6]

Discovery of Mine. The discovery of a mine or a natural deposit of mineral, whether it be made by an owner of the land or by a lessee, is to be defined as follows: (a) the bona fide discovery of a commercially valuable deposit of ore or mineral of a value materially in excess of the cost of discovery in natural exposure or by drilling or other exploration conducted above or below ground, or (b) the development and proving of a mineral or ore deposit which has been abandoned or apparently worked out, or sold, leased, or otherwise disposed of, by an owner or lessee prior to the development of a body of ore or mineral of sufficient size, quality, and character to determine it, in connection with the physical and geological conditions of its occurrence, to be a mineable deposit of ore or mineral having a value materially in excess of the cost of the proving and development. In determining whether a discovery has been made the Commissioner will take into account the peculiar conditions of the case, and every taxpayer claiming the value of a mineral deposit on the date of discovery or within 30 days thereafter for purposes of depletion will be required to attach to his return a statement setting forth the conditions and circumstances of the discovery and the size, character, and location of the deposit, together with the cost of discovery, its value, and the precise method used in determining the value.[7]

Charges to Capital and to Expense in the Case of Mine. In the case of mining operations all expenditures for plant equipment, development, rent, and royalty prior to production, and thereafter all major items of plant and equipment, must be charged to capital account for purposes of depletion and depreciation. After a mine has been developed and equipped to its normal and regular output capacity, however, the cost of additional minor items of

[6] Reg 45, Art. 217.

[7] Reg. 45. Art. 219. The term "discovery" has been defined in a number of cases relating to the location of mining claims, but the word "discovery" as used in this statute is not used in the sense employed in Revised Statutes, § 2320, under which section it has been held that a sufficient "discovery" to justify a location on public lands need not be a discovery that the ground contains mineral in sufficient quantities to pay. See Words and Phrases, Volume 3, p. 2094.

equipment and plant, including mules, motors, mine cars, trackage, cables, trolley wire, fans, small tools, etc., necessary to maintain the normal output because of increased length of haul or depth of working consequent on the extraction of mineral, and the cost of replacements of these and similar minor items of worn-out and discarded plant and equipment, may be charged to current expense of operations, unless the taxpayer elects to write off such expenditures through charges for depreciation.[8]

Depreciation of Improvements in Case of Mine. It is optional with the taxpayer, subject to the approval of the Commissioner, (a) whether the cost or value of the mining property, including ores and minerals, plant and equipment, and charges and additions to capital account not charged to expense and deducted as expense on the returns of the taxpayer, shall be recovered at a rate established by current exhaustion of mineral, or (b) whether the cost or value of the mineral and charges to capital account of expenditures other than for physical property shall be recovered by appropriate charges based on depletion and the cost or value of plant and equipment shall be recovered by reasonable charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. The value of a mining plant and equipment may not be reduced by depreciation or depletion deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, and no part of the value of land for purposes other than mining, is recoverable through depletion or depreciation.[9]

8 Reg. 45, Art. 222.
9 Reg. 45, Art. 224.

CHAPTER 29

DEPLETION OF OIL AND GAS WELLS

The provision of the Revenue Act of 1918 permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or other natural deposits and timber, has been set forth and discussed generally in another chapter.[1] This allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within 30 days after the date of discovery in the case of mines discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The essence of this provision is that the owner of such property, whether it be leasehold or freehold, shall secure through an aggregate of annual depletion and depreciation deductions the amount indicated in (a), (b), or (c), whichever applies to his particular case, plus in any case the subsequent cost of plant and equipment (less salvage value) and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors, and lessees are entitled to deduct an allowance for depletion, but a stockholder in a mining or oil or gas corporation is not.[2] The term "capital sum" is used in this chapter to denote the total amount recoverable to the taxpayer by means of depletion, depreciation, and obsolescence allowances.

"Capital Sum." Both "Cost of Property" and "Cost of Development," in so far as they have not been decreased by allowable deductions, are chargeable to capital sum and are returnable through the several allowable deductions. Structures and equip-

1 Revenue Act of 1918, §§ 214 (a) 10, 234 (a) 9.

2 Reg. 45, Art. 201. It has seemed necessary for the clearer understanding of this chapter to repeat some of the rules stated in Chapter 27; where possible, however, this has been avoided.

ment may also be included in capital assets and are returnable through depreciation. In the case of revaluations as of March 1, 1913, or within 30 days of a discovery by the taxpayer made subsequent to February 28, 1913, the value thus established plus consequent costs not otherwise deducted becomes the total of "Capital Sum." This revaluation, however, does not affect the Invested Capital. Development costs (except the cost of physical property) may be deducted as an expense in the year in which they are paid out or at the option of the taxpayer may be charged to capital sum. Election once made under this option is final and will control the returns for all subsequent years.[3]

COST OF PROPERTY. Cost of property includes all amounts (in cash or its equivalent) paid for and incident to the establishment of title and acquisition of the lease or freehold, as the case may be, such as—purchase price of lease or freehold; salaries or commissions paid to brokers or agents; fees to geologists, attorneys, surveyors, etc., for examination and defense of title, establishing boundaries, etc., state and county fees for recording and legalizing transfers, and all other payments made in acquiring and establishing title to the properties.[4]

COST OF DEVELOPMENT. Cost of development comprises all payments made for and incident to the drilling of wells, such as for (1) physical property; (2) geological and other surveys, made subsequent to acquisition; (3) roads; (4) water supplies; (5) hauling; (6) wages; (7) drilling; (8) shooting; (9) overhead charges (incident to drilling of wells); (10) fuel; and (11) all other similar expenditures.[5]

"Capital Sum" and "Invested Capital." The term *Capital Sum* is applied to the total amount returnable to the taxpayer through depletion, depreciation, and obsolescence allowances. It is to be clearly distinguished from the term "Invested Capital," which is the basis for the determination of war-profits credits and excess-profits credits of corporations. It has no necessary relation to the "invested capital." It may represent the investment of funds belonging to the taxpayer, or the investment of borrowed funds, which have no relation to invested capital; under

[3] Manual for the Oil and Gas Industry, p. 15.
[4] Manual for the Oil and Gas Industry, p. 15.
[5] Manual for the Oil and Gas Industry, p. 15.

the provisions of the law and regulations, the capital sum may include amounts based upon the right of valuation as of March 1, 1913, or within 30 days after the discovery of oil or gas by the taxpayer. Where such valuations are allowable, they have no application to invested capital, and may not be used for any purpose other than as a basis for depletion, depreciation, and obsolescence, or as a basis upon which to determine the gain or loss arising from the sale or surrender of property acquired prior to March 1, 1913. With respect to any allowance for amortization the basis is the cost of property acquired after April 5, 1917, and no amount may be added on account of revaluation.[6]

Capital Recoverable Through Depletion Allowance in Case of an Owner. In the case of operating owner in fee or lessor the capital recoverable through depletion allowances consists in—

[6] Manual for the Oil and Gas Industry, p. 13. The application of these principles is indicated in the following: A corporation had a paid-up capital stock of $50,000. This amount was invested in oil and gas property and in addition the corporation had incurred liabilities due to developing the property and the purchasing of equipment at the beginning of the taxable year amounting to $50,000. The property was found to have a value of $150,000 in accordance with the valuation accepted by the Commissioner. The allowable deductions for depletion and depreciation in determining the net income of the corporation are computed on the value of $150,000. The actual invested capital for the purpose of calculating the tax due for the taxable year from the corporation is $50,000. However, in the succeeding taxable year a part of the aggregate allowance for depletion and depreciation (proportionate to the part of the capital sum representing appreciation) may be included in invested capital in accordance with the provision of article 844 (2) of Regulations No. 45. The following statement is prepared to illustrate the application of the law to the case cited:

Assuming the total deduction for depletion, depreciation, and obsolescence from the gross income to be 10 per cent of the valuation accepted by the Commissioner, the amount deductible for the taxable year would be	$15,000
Amount of depletion, depreciation, and obsolescence calculated on the cost of the property is	10,000
The amount of realized appreciation which may be added to invested capital for the succeeding year is	5,000
Assuming that all the earnings are distributed, except the depletion and depreciation reserves, at the beginning of the succeeding taxable year, the invested capital would be	55,000
The cost of the property would be	90,000
The appreciation in value would be	45,000

(a) cost of the property, or its fair market value as of March 1, 1913, if acquired prior thereto, or its fair market value within 30 days of discovery, as the case may be; plus (b) cost of subsequent improvements and development not charged to current operating expenses; minus (c) deductions for depletion which have or should have been taken to date and minus (d) the portion of the capital sum as to which depreciation instead of depletion has been and is being deducted. The cost or value stated under (a) does not include the value of the land other than as the container of oil and gas. Depletion may be claimed against that portion of the cost or value which resides in the mineral deposit which is being exploited. To obtain this it is necessary to deduct from total cost or value the cost or value of the property other than as a container of oil and gas. Obviously, the *lessor* may not include in his capital sum any part of the discovery value or any part of the sums expended by the lessee in the development of the property, as mentioned under (b), and the operating owner in fee may include only such costs or values as have not been deducted as current operating expense or otherwise. Where depletion deductions for former years have or should have been taken, these amounts are to be subtracted from the capital sum returnable through depletion deductions. In no case may the account returnable through deductions for depletion include items against which depreciation is being charged; that is, the cost (or value) of physical property may not be included, since it is returnable through depreciation deductions.[7]

Capital Recoverable Through Depletion Allowances in the Case of Lessee. In the case of the lessee the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the leasehold, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery; plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which have or should have been taken to date, and (d) the portion of the capital sum, if any, as to which depreciation instead of depletion should be charged. Bonuses constitute a part of the cost of the leasehold. Any annual or periodical rents or flat royalties (as in the case of gas wells) *supplementing the*

[7] Reg. 45, Art. 202; Manual for the Oil and Gas Industry, p. 22.

bonuses or other amount paid for the lease at the time of acquisition may be charged to cost of leasehold until the property reaches the operating stage and will form part of the capital returnable through deductions for depletion.[8]

Apportionment of Deductions Between Lessor and Lessee. As the value of the property comprehends the interests of both lessor

[8] Reg. 45, Art. 203. The following illustration shows the effect of the rule stated in the text: A's invested capital in a leasehold on March 1, 1913, was $200,000. His estimated oil reserves on that date were 2,000,000 barrels. Under the 1913 Law, the lessee was not allowed a revaluation for purposes of computing his depletion deduction from gross income. And the depletion taken could not exceed 5 per cent of the value of the oil at the well.

$\frac{\$200{,}000}{2{,}000{,}000}$, or 10 cents, represents the unit cost of each barrel of oil in the property at that date.

He extracts and sells—

200,000 barrels in 1913 for	$100,000
150,000 barrels in 1914 for	90,000
125,000 barrels in 1915 for	60,000
100,000 barrels in 1916 for	50,000
75,000 barrels in 1917 for	100,000
He has sold 650,000 barrels for	$400,000

	Depletion sustained.	Depletion allowed.
1913	$20,000	$5,000
1914	15,000	4,500
1915	12,500	3,000
1916	10,000	10,000
1917	7,500	7,500
Total	$65,000	$30,000

For purposes of taxation in 1918 A's invested capital is $200,000—65,000=$135,000 and not $200,000—30,000=$170,000.

The Revenue Act of 1918 allows A to revalue his property as of March 1, 1913. The valuation ("Capital Sum") claimed by A and allowed by the Commissioner was $1,000,000.

The unit cost for purposes of computing depletion deductions from capital assets is $\frac{\$1{,}000{,}000}{2{,}000{,}000}$, or $0.50 per barrel.

The total depletion of capital sum to January 1, 1918, was, therefore, 650,000 × $0.50=$325,000.

Capital sum at January 1, 1918, is, therefore, $1,000,000—$325,000, or $675,000, and not $1,000,000—$30,000, or $970,000.

and lessee, no computation for the purpose of depletion allowances, of the value of these interests separately as of any date, which combined exceeds the value of the property in fee simple will be permitted. The same principle applies to holders of fractional interests. If the aggregate deduction claimed is deemed excessive, the Commissioner may request the owner or lessee to show that the valuation claimed does not exceed the fair market value of the property at a specified date. The lessor and lessee are required, with the approval of the Commissioner, to equitably apportion the allowance in the light of the peculiar conditions in each case and on the basis of their respective interests therein. To the return of every taxpayer claiming an allowance for depletion in respect of (a) a property in which he owns a fractional interest only, or (b) a leasehold, or (c) a property subject to a lease, there should be attached a statement setting forth the name and address and the precise nature of the holdings of each person interested in the property. In the case of the *lessor*, the depletion deduction is computed like that of the operating owner, except that ordinarily the only amount of capital to be returned is the cost of the oil or gas deposit if acquired subsequent to March 1, 1913, or its fair market value *en bloc* as of March 1, 1913, if acquired prior thereto, or within 30 days of discovery of oil or gas wells *if discovered by the taxpayer*. The value of the land for purposes other than as a container of oil or gas must always be deducted from the cost or value above to obtain the cost or value of the oil or gas deposits. Such cost or value divided by the estimated units of oil or gas in the ground on the date of acquisition or valuation will give the unit cost or value to be applied against the number of units removed from the lessor's property by the lessee, irrespective of the amount of oil received by the lessor as royalty. However, in cases where the property was leased before March 1, 1913, at a *fixed price per unit*, instead of a royalty payable in kind the lessor would be restricted by the valuation indicated by such fixed price, as fluctuations in the market value of oil subsequent to the lease would affect the valuation of the lessee only.[9]

Determination of Cost of Deposits. In any case in which a depletion or depreciation deduction is computed on the basis of the

[9] Reg. 45, Art. 204; Manual for the Oil and Gas Industry, p. 24.

cost or price at which any mine, mineral deposit, mineral rights, or leasehold was acquired, the owner or lessee will be required upon request of the Commissioner to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner, in fact as well as in form, different from the vendor. No fictitious or inflated cost or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof.[10]

Fair Market Value of Oil or Gas Properties. A determination of the fair market value of an oil or gas property (or the taxpayer's interest therein) is required: (a) In connection with the computation of depletion allowances: (1) *As of March 1, 1913,* in the case of properties acquired prior to that date; and (2) *At the date of discovery or within 30 days thereafter* in the case of oil and gas wells, discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease where the fair market value of the property is disproportionate to the cost; (b) In connection with computing the amount which may be included in paid-in surplus, *as of the date of conveyance,* where the tangible property has been conveyed to a corporation by gift or at a value accurately established or definitely known as to date of conveyance clearly and substantially in excess of the cash or of the par value of the stock or shares paid therefor; (c) In connection with the computation of profit and loss from sale of capital assets in the case of properties acquired prior to *March 1, 1913.*[11] The rules and tests and evidence bearing on the determination of market value are set forth in a previous chapter.[12] No revaluation of property will be permitted, as stated more fully in the same chapter.

10 Reg. 45, Art. 205. In general, the taxpayer will be required to submit the information called for in Schedule I of Form N.

11 Manual for the Oil and Gas Industry, p. 25.

12 See Chapter 27. In order to meet the requirements of the case to the satisfaction of the Commissioner the taxpayer should submit the information called for in Schedule II of Form N.

VALUATION OF FEE UNDER LEASE. The valuation of a fee ownership in oil or gas land under lease acquired prior to March 1, 1913, will have to do with the equity in its oil and gas contents remaining to the owner of the fee title after deducting the value of the lessee's rights. But subsequent investments or discoveries by the lessee will not affect the lessor's valuation.[13]

Determination of Quantity of Oil in Ground. In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the Commissioner, shall be made of the probable recoverable oil contained in the territory with respect to which the investment is made as of the time of purchase, or as of March 1, 1913, if acquired prior to that date, or within 30 days after the date of discovery, as the case may be. The oil reserves must be estimated for all undeveloped proven land as well as producing land. If information subsequently obtained clearly shows the estimate to have been materially erroneous, it may be revised with the approval of the Commissioner.[14] The estimate of probable recoverable oil in the ground is fundamentally necessary if a reasonable deduction for depletion is to be calculated, and, while it may be impossible to determine exactly the future production of a well or tract, it has been found possible to predict future productions with a comparatively narrow limit of error. The result of analysis of a great volume of production records has led to the development of the method suggested in the following paragraph.[15]

METHOD OF ESTIMATING RECOVERABLE RESERVES. The Treasury Department does not prescribe any particular method of estimating recoverable reserves, but the method described below is applicable to a wide variety of conditions and is inserted as a suggestion. The underlying principle of the method outlined is that *the best indication of the future production of any well is to be found in the history of similar wells in the same or similar districts,* and that, other things being equal, a well's production is more likely to approximate the production of a similar well in the tract or district than to deviate widely from the average. The method may be summarized as follows: 1. Plotting the record of production of individual wells, or, lacking

13 Manual for the Oil and Gas Industry, p. 26.

14 Reg. 45, Art. 209.

15 Manual for the Oil and Gas Industry, p. 27.

such detailed information, the average production per well for each tract. 2. Deriving from these graphical records an average or composite production decline curve for the district. 3. Estimating from the last year's average production per well the probable future production, based on the average production decline curve, or a future production curve derived from the production decline curve. 4. Ascertaining probable total future production of producing wells by multiplying average future production per well by the number of wells producing at the end of the year. 5. Estimating the probable future production of undeveloped proven land on the basis of near-by production, making due allowance for the decline in pressure due to the extraction of oil from the pool. It is to be emphasized that the value of estimates will depend almost entirely upon the skill with which the method is carried out and the character of the production records upon which they are based. Where accurate detailed records are not kept, it may be difficult to determine a "reasonable allowance for depletion." The taxpayer may estimate his recoverable reserves by any method that can be shown to be well founded, but in all cases the data upon which such estimate was based must be submitted, with a description of the method employed, and a résumé of the calculations.[16]

Computation of Allowance for Depletion of Oil Wells. In general, the allowance for depletion of oil wells is ascertained by multiplying the number of mineral units extracted from a well each year by the unit value. The unit value is ascertained by dividing cost, or value as of March 1, 1913, or within 30 days after discovery, by the number of mineral units in the property as of the date of acquisition or valuation.[17] Each barrel of oil or unit of gas extracted and marketed must, before a profit can be realized, pay not only its proportionate share of the operating expense and deductions for depreciation and obsolescence of physical property, but also must pay its proportionate share of capital sum returnable through depletion allowances. This proportionate share of

16 Manual for the Oil and Gas Industry, p. 27. See appendix for a full discussion of the estimation of recoverable underground reserves of oil. Average future production curves and tables for various districts of the United States are given at some length in the Manual for the Oil and Gas Industry, p. 75.

17 Reg. 45, Art. 210. For a full statement of this rule, see Chapter 27, p. 431.

capital sum returnable through depletion allowances, which each unit of oil or gas must pay, is ***unit cost.*** Unit cost is obtained by dividing the capital sum returnable through depletion by the "***estimated recoverable*** reserve" at the beginning of the taxable year. The depletion deduction is computed by multiplying the unit cost by the number of units produced during the taxable year. It is to be noted that the estimated recoverable reserves and the number of units produced are used in estimating the depletion deduction for both lessor and lessee. Since, however, they are applied to different capital amounts returnable through depletion deductions, the unit costs for lessee and lessor are not identical, and the deductions bear the same ratio as the capital sum of lessor and lessee. Usually the lessee's investment is greater than the lessor's and his deductions are correspondingly greater. Stated in another way, if a certain proportionate part of the lessee's capital returnable through depletion deductions is deducted in a given year the same ***proportion*** of the lessor's capital sum returnable through depletion will be deducted.[18]

[18] The following illustration shows the effect of the rule stated in the text:

A, a lessee, has an oil lease in which his original investment (exclusive of value of physical property) was	$20,000
Development cost (exclusive of cost of physical property) not otherwise deducted	80,000
Capital returnable through depletion allowance	$100,000
Estimated recoverable reserves at end of taxable year... barrels	400,000
Produced during taxable year... do	100,000
Estimated oil at beginning of year... do	500,000
Therefore unit cost is $\frac{\$100,000}{500,000}$, or per barrel	$0.20
A's depletion allowance for the taxable year is, therefore, $0.20 × 100,000, or	$20,000
B, the owner in fee of the property, had invested	$40,000
Of which the value of the land exclusive of oil rights represents	25.000
The investment in the oil deposit is	$15,000
B's unit cost is, therefore, $\frac{\$15,000}{500,000}$, or per barrel	$0.03

Computation of Allowance for Depletion of Gas Wells. The deductions allowed in computing income from natural-gas properties are in general similar to those allowed oil operators, but the method of computing the deductions and the various assets differ in certain particulars, the most notable of which are involved in the problems of estimating the probable reserves and computing the depletion. On account of the peculiar conditions surrounding the production of natural gas it will be necessary to compute the depletion allowances for gas properties by methods suitable to the particular cases in question and acceptable to the Commissioner. Usually, the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. In many fields more or less additional evidence on depletion is to be had from such considerations as (a) details of production and performance records of well or property, (b) decline in open flow capacity, (c) comparison with the life histories of similar wells or properties, particularly those now exhausted, and (d) size of reservoir and pressure of gas. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The follow-

And his depletion allowance for the same year $0.03×100,000, or....	$3,000

The above example presupposes that B leased his land without bonus.

Any amount received by a lessor as bonus for an oil and gas lease on the property would reduce his capital sum by that amount.

Illustration:

The lessor's (B's) investment in the deposit is....................	$15,000
He receives as bonus	5,000
His net investment in the deposit is, therefore....................	$10,000
He sells a one-half interest in his royalty for....................	$6,000
As this half cost him..	5,000
His profit is	$1,000
And is subject to tax as income.	
His capital sum remaining is..................................	$5,000
If he had sold a one-half interest in his royalty for................	4,000
He would have sustained a loss of..............................	$1,000

and should deduct this amount from gross income as a loss in computing his tax.

ing formula, in which the units of gas are pounds per square inch of closed pressure, may be used and is recommended: the quotient of the capital account recoverable through depletion allowances to the end of the taxable year, divided by the sum of the pressures at the beginning of the year less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost), multiplied by the sum of the pressures at the beginning of the taxable year plus the sum of the pressures of new wells less the sum of the pressures at the end of the tax year, equals the depletion allowance.[19] The above methods are more fully discussed in the following paragraphs.

DETAILS OF PRODUCTION OR THE PERFORMANCE RECORD OF THE WELL OR PROPERTY. As a general rule the demand on a natural gas property is a variable factor. In certain fields, however, the demand from some wells has from the beginning, or for considerable periods, been greater than the supply, so that the amount of gas marketed per well may, as in the case of oil, show a regular decline, which will be indicative of the total amount that the well may be expected to produce, and also the rate of production. Even where the demand does not greatly exceed the supply, the amount and rate of past production may in certain cases throw light on the future of the well or property.[20]

DECLINE IN OPEN-FLOW CAPACITY. Where data are available the decline in open-flow capacity indicates in a general way the rate of exhaustion of the gas field. The relationship is not at all close and varies from field to field and from well to well. Also for most gas wells accurate data on decline in open-flow capacity are not available. Nevertheless it is probable that for certain properties this method will have value, for with rare exceptions the production of gas from a well leads to a decline in its capacity, and the fraction produced is roughly proportional to the decline.[21]

COMPARISON WITH LIFE HISTORY OF SIMILAR WELLS OR PROPERTIES PARTICULARLY THOSE NOW EXHAUSTED OR NEARING EXHAUSTION. Where no other data are available the rate of depletion of a gas well or property may be approximated by comparison with a neighboring well or property that has reached a later stage in life. Particularly is this applicable in a district where many gas

19 Reg. 45, 211; Manual for the Oil and Gas Industry, p. 29.

20 Manual for the Oil and Gas Industry, p. 30.

21 Manual for the Oil and Gas Industry, p. 30.

wells have become exhausted. For example, in a region where wells produce from 8 to 12 years, or an average of 10 years, a 10 per cent deduction will be a rough approximation of the rate of depletion.[22]

SIZE OF RESERVOIR AND PRESSURE OF GAS, OR THE PORE-SPACE METHOD. For some properties the pore-space method may be best for estimating underground supplies of natural gas and for a good many it will furnish additional evidence of value. The method would be ideal if the average percentage of pore-space, the extent and thickness of the sand, and the pressure of the gas could be accurately ascertained. In computing the reserves of an individual property by this method the migratory character of gas must be considered and the production and behavior of adjacent properties taken into account. The factors that make the method difficult to apply are difficulty of accurately ascertaining the thickness of pay, limits of pool, percentage of pore space, the effect of encroaching water and oil, and the quantity of gas remaining when commercial production is no longer possible. Take, for example, a pool where there is no encroachment by water. Suppose that the pore space is 25 per cent, the thickness of the pay 20 feet, and the extent of the pool 10 square miles, or roughly 280,000,000 square feet. The volume of the reservoir would be 1,400,000,000 cubic feet, and the amount of gas in the sand could be readily computed by taking into account the closed pressure of the wells.[23]

OTHER INDICATIONS OF DEPLETION. Additional evidence of decreasing supply of natural gas in the ground is commonly observable in the behavior of the wells and the provision that must be made for transporting the gas to market. Observations on minute pressures show more or less progressive change as the wells become older and an increasing amount of gas is drawn from the ground. Line pressures and pressures at compressing stations are also likely to show a progressive change in the same direction. The appearance of water or oil in a gas well or in neighboring gas wells may be a very significant symptom of the approaching termination of the life of the well. The clogging of

[22] Manual for the Oil and Gas Industry, p. 30.
[23] Manual for the Oil and Gas Industry, p. 30.

gas wells by paraffin, salt, or other deposits may demand modification of depletion estimates.[24]

CLOSED-PRESSURE METHOD. Because of its general applicability, the closed-pressure method is by far the best method of estimating the depletion of gas properties. Unfortunately, accurate closed-pressure data have not been kept for all properties or perhaps even for the majority of properties, but the rock pressure in most pools is known or is ascertainable with a fair degree of accuracy, and the information drawn from the pressure decline is, with the exception of a few fields, not subject to profound modification because of factors whose value can not be appraised. The basis of this method is Boyle's law. According to this law of physics, if gas is pumped into a vessel until the pressure is 200 pounds and then is drawn off until the pressure is 100 pounds, the size of the vessel remaining fixed, and ignoring for the moment atmospheric pressure, it may be concluded that one-half of the gas has been drawn out of the vessel. If an underground gas reservoir of fixed dimensions is tapped by wells and the pressure is found to be a thousand pounds, and then if the gas is drawn off through the wells until the gas pressure in the pool is lowered to 100 pounds, we may infer that about nine-tenths of the supply of gas has been exhausted.[25]

"UNIT COST" AS APPLIED TO NATURAL GAS. Although, as a rule, the number of cubic feet of gas under a tract can not be satisfactorily estimated and the quantity that will be marketed is even less definite, the "unit cost method" can be used by regarding pounds of closed pressure as units, for the actual quantity of gas underground commonly varies with the decline in pressure and the relative quantity at the beginning and end of the tax year and at the time of abandonment, is, in the lack of better information, usable for tax purposes.[26]

CORRECTIONS AND REFINEMENTS OF CLOSED-PRESSURE METHOD. Several corrections and more or less important refinements are made in applying this method to the computation of depletion. and it should be borne in mind that it does not afford data on the *amount* of gas originally in the pool or at any later specified

24 Manual for the Oil and Gas Industry, p 31.
25 Manual for the Oil and Gas Industry, p. 31.
26 Manual for the Oil and Gas Industry, p. 31.

time, but only the *fraction* of the gas that has been removed from its natural reservoir and the fraction remaining in that reservoir. Perhaps the most important of these corrections arises out of the fact that the size of the reservoir does not remain fixed but becomes smaller as the gas is drawn and water or oil advances into a part of the space formerly occupied by the gas. The pressure is thus prevented from declining at a rate proportionate to the amount of gas drawn from the pool. The correction on account of water or oil encroachment is difficult to make, because of the lack of data to determine the extent of the encroachment. However, in a good many pools, after a study of the distribution of wells that have been "drowned out" and the history of water troubles in similar near-by pools, it is possible to make allowance for water or oil encroachment which will more or less closely approximate the facts. Another refinement applicable to the computation of depletion of natural gas by the closed-pressure method is based upon the fact that even where there is no encroachment of water or oil the depletion is not precisely represented by the gauge readings, though the errors are generally so small that they may be ignored. For example, where the pressure declines from 1,000 to 500 pounds, the gas is not exactly half gone, for the reason that the pressures referred to are gauge readings and to each should be added the pressure of the atmosphere—for most fields about 14.4 pounds to the square inch. The fraction remaining in the ground then becomes $\frac{514.4}{1014.4}$. Account should also be taken of the pressure at which wells are abandoned in the field or district. If wells can not be operated with profit after the pressure has declined to 25 pounds gauge reading (39.4 pounds absolute), then the percentage of recoverable gas remaining when the pressure has declined from 1,000 to 500 pounds gauge reading is not one-half or even the fraction $\frac{514.4}{1014.4}$ but $\frac{475}{975}$. The difference in the fraction where pressures of several hundred pounds are involved is not great and scarcely worth considering in view of the other errors which are certain to affect the result. However, after the pressure has declined to a low figure, the matter of correcting the fraction becomes of considerable importance. Thus, if the pressure of abandonment is 4 pounds gauge reading and during the year the average closed pressure of a pool has declined from 10 pounds to

5 pounds gauge reading, five-sixths instead of one-half of the recoverable gas has been withdrawn. Still another refinement that has, as a rule, more theoretical than practical value may be worthy of consideration in certain instances. This arises out of the fact the gases do not expand precisely as the pressure decreases, and that even if the size of the natural reservoir remains fixed the pressure does not decline in exact proportion to the amount of gas removed. The difference amounts to only a few per cent and is greatest for high pressures. In the decline from 1,000 to 500 pounds per square inch the gas expands several per cent more than would be calculated by a strict application of Boyle's law, and in a decline from 1,500 pounds to 1,000 pounds the departure is still greater. The correction varies from field to field because of the different constitution of the gases, though since most natural gases consist largely of methane the variations on account of differences in gases are not great. A fourth detail of refinement arises out of the fact that on the average more gas is marketed for 50 pounds of decline in pressure after the pressure has reached 100 pounds or less than an equal decline while the pressure is high, as, for example, 1,000 pounds per square inch. Also the expense of marketing gas after the pressure has become low is greater than when it was high, largely because of the necessity of installing compressors to push the gas through the pipe lines to the consumers. These two considerations have a tendency to balance each other and, with certain exceptions, will not be of sufficient importance to warrant an attempt to apply the corrections.[27]

METHOD OF GAUGING. In using the closed-pressure method of estimating depletion, the method of gauging is of vital importance and in many fields is not carried out with sufficient care. Care should be taken to make sure that the gauge is accurate, testing it before and after attaching it to the well. If it must be transported far or is subject to much jolting in transportation, a gauge tester should be taken along and used at the well. Care should also be taken to empty the well of oil and water by pumping, blowing, or siphoning before attaching the gauge, for any liquid in the hole will lower the closed pressure reading. The well should be closed long enough to allow the pressure to build

27 Manual for the Oil and Gas Industry, p. 32.

up to its maximum. The length of time necessary for this purpose varies a great deal from field to field and well to well. The well should remain closed until the pressure will not build up more than 1 per cent in 10 minutes. Ordinarily, 24 hours will be sufficient for this purpose, but for some wells several days or even a longer period will be required, owing to the slowness of equalization of pressure in the sand.[28]

APPORTIONMENT OF DEPLETION AMONG VARIOUS SANDS. Where more than one sand under a property is yielding gas, the problem arises as to how to weight or evaluate the decline in pressure in the different sands. Suppose there is a very good gas sand in which the pressure declines from 600 to 300 pounds during the year, and a very poor sand in which the pressure declines from 800 to 750. The depletion sustained is not indicated by the average decline in pressure but is more nearly proportionate to the decline in the good sand. If accurate figures on capacities of wells are obtainable, it will be possible to make a fairly accurate weighting of the pressure declines, or if facts indirectly indicating capacity of individual wells are obtainable some light may be thrown on the question. But, as a general rule, it is necessary to average the decline of wells drawing from different sands as though they were drawing from the same sand.[29]

SEASON FOR TESTING WELLS FOR CLOSED PRESSURE. For many fields summer or early fall readings furnish the best indication of decline in closed pressure. It is therefore recommended that such readings be taken regularly and consistently. Summer or fall readings are of especial value because these seasons for most fields are at the end of a period during which the wells have not been subject to heavy draft, and hence are in best condition to accurately reflect the pressure of the gas in the underground pool or reservoir. If pressures of all wells or representative wells are observed regularly and carefully in summer or early fall, these readings may in many cases be applied direct to the end of the taxable year, though in some cases it may be possible and desirable to estimate the pressures at the end of the taxable year from pressures observed at other times. Obviously, it will not be possible to test the pressures of all wells at the exact end of the tax-

[28] Manual for the Oil and Gas Industry, p. 33.
[29] Manual for the Oil and Gas Industry, p. 33.

able year. If in one part of a tract a gas well is brought in at a pressure of 1,000 pounds and during the remainder of the taxable year the pressure declines to 700 pounds, the rough inference may be drawn that three-tenths of the gas has been taken from the tract and, subject to corrections in certain cases, three-tenths of the capital returnable through depletion may be charged off. Suppose that sometime in the next taxable year a gas well is completed on another part of the tract and that its initial pressure is 800 pounds. If by the end of the year the pressure of this well has declined to 700 pounds while the pressure of the first well has dropped to 500 pounds, the fraction of the capital account returnable through depletion the second year is proportional to the average decline in pressure, assuming that there are no water troubles or other noteworthy complications. The average of 700 and 800 is 750 and the average of 500 and 700 is 600. The difference or average decline in pounds or units of gas is 150, and this represents a decline of 20 per cent from 750. It will be noted that the exact date of completion of the new well does not enter the computation and it is treated as though it were finished at the beginning of the year. The rate of decline within the year is of little consequence, the main consideration being the amount of decline for the whole year. If the year's decline occurred within a month, or even a week, it is treated the same as though it were spread over the entire year. Abandoned wells may be regarded as fully depleted and their pressure counted as zero in computing depletion. Consider the wells just described and assume that in the third year a third well is brought in and one of the old wells is abandoned. Suppose the pressure at the first well declined from 500 pounds to about zero and the well is abandoned, the second well to 300 pounds and the third to 600. The pressure of the two old wells at the beginning of the year and of the new one at its completion averaged 600 pounds, and the average of the three at the end of the year was 300. The depletion indicated is 50 per cent of the remaining capital account. It is suggested that the capital sum at the beginning of each year be treated as 100 per cent for the average pressure at the beginning of the year, and the average decline during the year will then furnish a readily usable basis for computing the depletion allowance. The amount of gas in the ground is, as a rule, to be regarded as limited to the proven territory so that as new wells are drilled and

the territory is enlarged, or new gas-bearing sands are discovered, the denominator of the fraction indicating depletion varies from year to year.[30]

FORMULA.[31] The following discussion is offered for the use of those who prefer to use a formula in computing the depletion allowance. Perhaps the simplest formula may be written:

$$\frac{x}{y} \times z = \text{depletion allowance.}$$

In this formula x stands for the capital sum to the end of the year; y is the total future pressure decline or the difference between the sum of the pressures at the beginning of the tax year and the sum of the pressures at the time of expected abandonment; z is the pressure decline during the year as obtained by adding to the sum of the pressures at the beginning of the year the sum of the pressures of any new wells completed during the year and subtracting the sum of the pressures at the end of the year. The formula may also be written as follows:

$$\frac{\text{Capital sum to end of tax year}}{\text{Sum of the pressures at beginning of year} - \text{sum of pressures at time of expected abandonment.}} \times \begin{matrix}\text{Sum of pressures}\\ \text{at beginning of}\\ \text{tax year} + \text{sum}\\ \text{of pressures of}\\ \text{new wells} -\\ \text{sum of pres-}\\ \text{sures at end of}\\ \text{tax year.}\end{matrix} = \begin{matrix}\text{Depletion}\\ \text{allowance.}\end{matrix}$$

Gas Well Pressure Records to Be Kept. Beginning with 1919 closed pressure readings of representative wells, if not of all wells, must be carefully made and kept. In order to standardize pressure readings the well should remain closed until the pressure does not build up more than 1 per cent of the total pressure in ten minutes. Ordinarily 24 hours will suffice for this purpose, but some wells will need to remain closed for a longer period. If there is any water in the well it should be blown or pumped off before the well is closed. A closed pressure reading of a gas well which has been producing, or is near gas wells that have been producing, is lower than the actual pressure of the gas in the reservoir by an

[30] Manual for the Oil and Gas Industry, p. 34.
[31] Manual for the Oil and Gas Industry, p. 35.

amount depending on the well's location with reference to other producing wells and the length of time it has been closed in. It is necessary to record the length of time the well has been closed and to show how the pressure built up during this period. Successive readings will indicate the point at which the pressure becomes approximately stationary, that is, the point at which the closed pressure approaches as nearly as possible the maximum pressure which would be shown if all wells in the pool were closed for several months. The length of time required varies with the character of the sand, position of the packer, the location of the well with reference to other wells, the limits of the pool, and other factors. The depth of the well, diameter of tubing, and line pressure when the well was shut off, should be noted. Since readings at the exact end of the taxable year will ordinarily not be available, the pressure of that date may be obtained by interpolation or extrapolation. In certain cases readings taken regularly in September or some other month may be applicable to the end of the taxable year. As a general rule September closed pressure readings furnish the best indication of depletion and it is recommended that such readings be made with regularity and care. Where interpolated or extrapolated readings are used the data from which they are obtained should be given. Gauges should be of appropriate capacity and should be frequently tested. A record should be kept of the number of gauges, date each was tested, names of men testing, and other significant details.[32]

Computation of Allowance Where Quantity of Oil or Gas Uncertain. If by reason of the youth of the field, the restricted production, or for any other cause, it is not possible to determine with any degree of certainty the quantity of oil or gas in a property, it will be necessary to make a tentative estimate which will apply until production figures are available from which an accurate determination may be made.[33]

Computation of Depletion Allowance for Combined Holdings of Oil and Gas Wells. In the case of owners of property containing oil wells and gas wells the rulings are as follows:

OIL PROPERTIES. The recoverable oil belonging to the tax-

[32] Reg. 45, Art. 212.
[33] Reg. 45, Art. 213.

payer should be estimated separately on the smallest unit on which data are available, such as individual wells or tracts, and these added together into a grand total to be applied to the total capital account returnable through depletion. The capital sum should include the cost or value, as the case may be, of all oil or gas leases or rights within the United States and its possessions, plus all incidental costs of development not charged as expense nor returnable through depreciation. The unit value of the total recoverable oil or gas is the quotient obtained by dividing the total capital account recoverable through depletion by the total estimated recoverable oil or gas. This unit multiplied by the total number of units of oil or gas produced by the taxpayer during the taxable year from all of the oil and gas properties will determine the amount which may be allowably deducted from the gross income of that year.[34] In the case of sale of particular tracts, full account must be taken of the depletion of such tracts in computing profit or loss thereon.[35]

GAS PROPERTIES. In the case of the gas properties of a taxpayer the depletion allowance for each pool may be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressures of all the taxpayer's wells in such pool as in the formula given elsewhere in this book.[36] The total allowance for depletion of the gas properties of the taxpayer will be the sum of the amounts computed for each pool.[37] The depletion of gas supplies belonging to a taxpayer may be more accurately computed by making estimates for each tract, though it is quite possible that the expense of making separate estimates for individual tracts may be greater than the benefits arising from such a procedure.[38]

Statement to Be Attached to Return Where Depletion of Oil or Gas Claimed. To each return made by a person owning or operating oil or gas properties, there should be attached a statement showing for each property the following information,

34 Reg. 45, Art. 214.
35 Manual for the Oil and Gas Industry, p. 36.
36 See p. 459.
37 Reg. 45, Art. 214.
38 Manual for the Oil and Gas Industry, p. 37.

which may be given in the form of a table, if desired, by taxpayers owning more than one property: (a) the fair market value of the property (exclusive of machinery, equipment, etc., and the value of the surface rights) as of March 1, 1913, if acquired prior to that date; or the fair market value of the property within 30 days after the date of discovery; or the actual cost of the property, if acquired subsequently to February 28, 1913, and not covered by the foregoing clause; (b) how the fair market value was ascertained, if the property came under the first or second head under (a); (c) the estimated quantity of oil or gas in the property at the time that the value or cost was determined; (d) the name and address of the person making the estimate and the manner in which this estimate was made, including a summary of the calculations; (e) the amount of capital applicable to each unit (this being found by dividing the value or cost, as the case may be, by the estimated number of units of oil or gas in the property at the time the value or cost was determined); (f) the quantity of oil or gas produced during the year for which the return is made (in the case of new properties it is desirable that this information be furnished by months); (g) the number of acres of producing and proven oil or gas land; (h) the number of wells producing at the beginning and end of the taxable year; (i) the date of completion of wells finished during the taxable year; (j) the date of abandonment of all wells abandoned during the taxable year; (k) a property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas lands; (l) the average gravity of the oil produced on the tract; (m) the number of pay sands and average thickness of each pay sand or zone on the property; (n) the average depth to the top of each of the different pay sands; (o) any data regarding change in operating conditions, such as flooding, use of compressed air, vacuum, shooting, etc., which have a direct effect on the production of the property; (p) the monthly or annual production of individual wells and the initial daily production of new wells (this is highly desirable information and should be furnished wherever possible); (q) (for the first year in which the above information is filed for a property which was producing prior to the taxable year covered by the above statement the

following information must be furnished) annual production of the tract or of the individual wells, if the latter information is available, from the beginning of its productivity to the beginning of the taxable year for which the return was filed; the average number of wells producing during each year; and the initial daily production of each well; and (r) any other data which will be helpful in determining the reasonableness of the depletion production.[39]

MAPS. Maps that accompany records and delineate property boundaries must be sufficiently extended to show the position of property in relation to section, township, and range lines, or in areas of metes and bounds survey, the relation to two or more established lines, of either township or district. On some part of the map should be recorded the name of the State, county, township, or district, name of the company or individual representing property, scale of map, and date of survey, and points of the compass. It will be to the advantage of every taxpayer to assist the department in compiling complete statistics of all development that has taken place, and maps submitted should show location of all wells that have ever been drilled on a given property. The character of each well should be indicated by appropriate symbols. Where wells have been drilled by another company or individual it is advisable to distinguish such wells by some symbol or abbreviation, explaining the symbol in a marginal note. When a taxpayer has filed adequate maps with the Commissioner he may be relieved of filing further maps of the same properties, provided all additional information necessary for keeping the maps up to date is filed each year. This includes records of dry holes as well as producing wells, together with logs, depth, and thickness of sands, location of new wells, etc. By "production" is meant the production of oil or gas belonging to the taxpayer. In those leases where no account is kept of the oil or gas used for fuel, the net production will necessarily be that remaining after the fuel used in the property has been taken out. In cases of this kind an estimate of the fuel used from each tract should be given for each year.[40]

[39] Reg. 45, Art. 218.

[40] Manual for the Oil and Gas Industry, p. 39.

Discovery of Oil and Gas Wells. The discovery clause of the statute provides that taxpayers who discover oil and gas wells on or after March 1, 1913, may, under the circumstances therein prescribed, determine the fair market value of such property at the date of discovery or within 30 days thereafter for the purpose of ascertaining allowable deductions for depletion. Before such valuation may be made the statute requires that two conditions precedent be satisfied, (1) that the fair market value of such property (oil and gas wells) on the date of discovery or within 30 days thereafter became materially disproportionate to the cost, by virtue of the discovery, and (2) that such oil and gas wells were not acquired as the result of purchase of a proven tract or lease.[41]

DISCOVERY—PROVEN TRACT OR LEASE—PROPERTY DISPROPORTIONATE VALUE. (1) For purposes of the discovery clause of the Revenue Act of 1918, an oil or gas well may be said to be discovered when there is either a natural exposure of oil or gas, or a drilling that discloses the actual and physical presence of oil or gas in quantities sufficient to justify commercial exploitation. Quantities sufficient to justify commercial exploitation are deemed to exist when the quantity and quality of the oil or gas so recovered from the well are such as to afford a reasonable expectation of at least returning the capital invested in such well through the sale of the oil or gas, or both, to be derived therefrom. (2) A proven tract or lease may be a part or the whole of a proven area. A proven area will be presumed to be that portion of the productive sand or zone or reservoir included in a square surface area of 160 acres having as its center the mouth of a well producing oil or gas in commercial quantities. In other words, a producing well will be presumed to prove that portion of a given sand, zone or reservoir which is included in an area of 160 acres of land, *regardless of private boundaries*. The center of such square area will be the mouth of the well, and its sides must be parallel to the section lines established by the United States system of public land surveys in the district in which it is located. Where a district is not covered by the United States land surveys, the sides of said area must run north and south, east and west. So much of a taxpayer's tract or lease which lies within an area

41 Reg. 45, Art. 220, as amended by T. D. 2956, Dec. 2, 1919. This Treasury Decision substantially modifies the former ruling of the Treasury Department.

proven either by himself or by another is "a proven tract or lease" as contemplated by the statute, and the discovery of a well thereon will not entitle such taxpayer to revalue such well for the purpose of depletion allowances, unless the tract or lease had been acquired before it became proven. And even though a well is brought in on a tract or lease not included in a proven area as above defined, nevertheless it may not entitle the owner of the tract or lease in which such well is located to revaluation for depletion purposes, if such tract or lease lies within a compact area which is immediately surrounded by proven land, and the geologic structural conditions on or under the land so inclosed may reasonably warrant the belief that the oil or gas of the proven areas extends thereunder. Under such circumstances the entire area is to be regarded as proven land. (3) The "property" which may be valued after discovery is the "well." The "well" is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area. (4) A taxpayer to be entitled to revalue his property after March 1, 1913, for the purpose of depletion allowances must make a discovery after said date and such discovery must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the output of such well of oil or gas affords a reasonable expectation of returning to the taxpayer an amount materially in excess of the cost of the land or lease if acquired since March 1, 1913, or its fair market value on March 1, 1913, if acquired prior thereto, plus the cost of exploration and development work to the time the well was brought in.[42]

Proof of Discovery of Oil and Gas Wells. In order to meet the requirements of the discovery clause of the statute to

[42] Reg. 45, Art. 220a, as amended by T. D. 2956; Manual for the Oil and Gas Industry, p. 40. The same evidence as required under "Determination of fair market value," p. 430, must be submitted by the taxpayer to substantiate the value which he sets up as of date of the discovery or within 30 days thereafter in the cases under discussion.

(See Schedules I, II. and III, of Form N.)

the satisfaction of the Commissioner, the taxpayer will be required, among other things, to submit the following with his return: (a) a map of convenient scale, showing the location of the tract and discovery well in question and of the nearest producing well, and the development for a radius of at least three miles from the tract in question, both on the date of discovery and on the date when the fair market value was set; (b) a certified copy of the log of the discovery well, showing the location, the date drilling began, the date of completion and beginning of production, the formations penetrated, the oil, gas, and water sands penetrated, the casing record, including the record of perforations, and any other information tending to show the condition of the well and the location of the sand or zone from which the oil or gas is produced on the date the discovery was claimed; (c) a sworn record of production clearly proving the commercial productivity of the discovery well; (d) a sworn copy of the records, showing the cost of the property; and (e) a full explanation of the method of determining the value on the date of discovery or within 30 days thereafter, supported by satisfactory evidence of the fairness of this value.[43]

Charges to Capital and to Expense in the Case of Oil and Gas Wells. Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital accounts returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years. Casing-head-gas contracts have been construed to be tangible assets and their cost may be added to the capital ac-

[43] Reg. 45, Art. 221, as amended by T. D. 2956.

count returnable through depletion, following the rate set by the oil wells from which the gas is derived, or, if the life of the contract is shorter than the reasonable expectation of the life of the wells furnishing the gas, the capital invested in the contract may be written off through yearly allowances equitably distributed over the life of the contract. All oil produced during the taxable year, whether sold or unsold, must be considered in the computation of the depletion allowance for the taxable year. In computing net income all oil in storage at the beginning and at the end of the taxable year must be inventoried at cost, that is, unit cost plus lifting cost. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[44]

Depreciation of Improvements in the Case of Oil and Gas Wells. Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for the depletion or return of capital, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under the preceding paragraph.[45] The amount deductible on this account will be such an amount based upon its cost or fair market value as of March 1, 1913, equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit.[46]

[44] Reg. 45, Art. 223.
[45] See p. 466.
[46] Reg. 45, Art. 225. See Chapter 26 for a discussion of depreciation.

PHYSICAL PROPERTY. Physical property is defined as all equipment having an inventory or salvage value and subject to removal from the property, such as buildings, bridges, and power plants; derricks, casings, drilling equipment (cable and rotary), and pumping equipment, including engines, boilers, tubing, and rods; flow lines, and connections on wells, tanks attached to wells, and other tankage of steel, wood, or concrete; cleaning and pulling equipment; salt-water equipment; refineries, treating and reducing plants, including casinghead gas plants; telegraph and telephone lines, pipe lines and tank cars, and all other equipment used in the production, reduction, conservation, or transportation of oil and gas or their products.[47]

ESTIMATES OF DEPRECIATION OF PHYSICAL PROPERTY. Some percentages and tables used in the estimation of depreciation of oil and gas property and intended as a suggestion for the guidance of the taxpayer in calculating his just tax are set forth in the appendix. The percentages are neither maximum nor minimum rates. They are *not to be applied indiscriminately to specific property,* and the Internal Revenue Bureau is in no way committed to accept allowances based upon them. Every claim for deduction must be accompanied by a detailed statement of the facts upon which such claim is based. Each class of equipment is shown in detail and as a class, with the suggestion that an average life of the class be used rather than going into the details of every part. The average years of useful life of the various classes is shown in the summary sheet and a suggestion for charging out annual percentages to conform to the depreciation as it actually occurs. It must be borne in mind that it is not possible to make standard rules or formulæ to cover all conditions in this business. Although different rates may reasonably be applied in different parts of the country, it is believed that the variation of such rates from the general average is so slight as to be practically negligible in most instances. Whenever the life of the property is materially shorter than that called for in this schedule, a special rate may be claimed, or the differences may be made up by replacements chargeable to the maintenance accounts. In the case of some of the Gulf coast districts, portions of the pipe lines are eaten out in five or six years. These

47 Manual for the Oil and Gas Industry, p. 14.

repairs are rightly a replacement and chargeable to maintenance or operating accounts. Depreciation deductions are to be charged to a reserve fund, and are in addition to any regular charge for repairs and operating maintenance. No consideration has been given exceptional cases where premature failure of supply or market may materially reduce the given life of the facility. Such cases are necessarily exceptional and will receive special consideration.[48]

Depletion and Depreciation of Oil and Gas Wells in Years Before 1916. If upon examination it is found that in respect of the entire drilling cost of wells, including physical property and incidental expenses, between March 1, 1913, and December 31, 1915, a taxpayer has been allowed a reasonable deduction sufficient to provide for the elements of exhaustion, wear and tear, and depletion, it will not be necessary to reopen the returns for years prior to 1916 in order to show separately in these years the portions of such deduction representing depletion and depreciation, respectively. Such separation will be required to be made of the reserves for depreciation at January 1, 1916, and proper allocation between depreciation and depletion must be maintained after that date. In any case in which it is found that the deductions taken between March 1, 1913, and December 31, 1915, are not reasonable, amended returns may be required for these years.[49]

48 Manual for the Oil and Gas Industry, p. 56.
49 Reg. 45, Art. 226.

CHAPTER 30

DEPLETION OF TIMBER

The provision of the Revenue Act of 1918 permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or other natural deposits and timber, has been set forth and discussed generally in another chapter.[1] This allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto. The essence of this provision is that the owner of timber property, whether it be a leasehold or a freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to its fair market value as of March 1, 1913, plus in any case the subsequent cost of plant, equipment, and development which is not chargeable to current operating expenses, but not including cut-over land values.[2] The allowance is permitted to operating owners, lessors and lessees, and the capital recoverable through the depletion allowance in the case of each and the rules with respect to the apportionment of the deduction between lessor and lessee are also set forth generally in another chapter.[3] The cost of timber property is determined in accordance with the rules laid down in the same chapter.[4] Certain special rules specifically relating to the depletion allowance in the case of timber are set forth below.

1 See Chapter 27.

2 Reg. 45, Art. 227. Prior to the 1918 Law the statute did not provide for depletion of timber lands, but the Treasury Department prescribed rulings under which a deduction could be taken from gross receipts or made through a charge in the cost of manufacturing the timber into lumber. These rulings were practically to the same effect as those discussed in this chapter.

3 See Chapter 27.

4 This chapter should be consulted in connection with the rules discussed in this chapter. Many of the rules stated in chapter 29 on Oil and Gas Wells have a more general application and should be consulted also.

Determination of Fair Market Value of Timber. Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the most reliable and accurate information with reference to the condition of the property as it existed at that date, regardless of all subsequent changes such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. No rule or method of determining the fair market value of timber property is prescribed, but the Commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods, and other factors. For depletion purposes the cost of the timber or its fair market value at a specified date will not include any part of the cost or value of the land.[5]

Determination of Quantity of Timber. Each taxpayer claiming a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. The taxpayer, according to his best knowledge and belief and in the light of the most accurate and reliable information, will estimate the number of units of timber actually present upon the specified date; this estimate will state the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100 per cent of the quantity of timber which the area would have produced on that

[5] T. D. 2916; Reg. 45, Art. 234.

date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return additional units of timber are found to be available for utilization as the result of the growth of the timber, of closer utilization of the timber, of the utilization of species of trees not formerly utilized, of underestimates of the quantity of timber available on the specified date, etc., which were not taken into account in estimating the number of units for purposes of depletion, or if it shall be found in the course of operation that timber included in the estimate is not merchantable as the result of deterioration through rot or otherwise, or that the original estimate was too great, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) must be made and when made must thereafter constitute a basis for depletion. In the selection of the unit or units of estimate the custom applicable to the given type of timber in the given region should be considered.[6]

Computation of Allowance for Depletion of Timber. An allowance for the depletion of timber in any taxable year must be based upon the number of feet of stumpage cut during the year and the unit cost of the stumpage at the date of acquisition or the unit market value on March 1, 1913, if acquired prior thereto. The unit market value as of March 1, 1913, will be the unit price at which the standing timber in its then condition and in view of its then environment could have been sold for cash or its equivalent. The amount of the deduction for depletion in any taxable year will be the product of the number of feet of stumpage cut during the year multiplied by such unit cost or market value of the stumpage.[7]

Revaluation of Stumpage. The fair market value of stumpage when determined as of March 1, 1913, for the purpose of depletion allowances in the case of timber acquired prior thereto, will be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the stumpage was fixed, and during such ownership there can be no redetermination of the fair market value of

6 T. D. 2916; Reg. 45, Art. 235.
7 Reg. 45, Art. 229.

the stumpage for such purpose. However, the unit market value of stumpage adopted by the taxpayer may subsequently be changed if from any cause such value, if continued as a basis of depletion, should upon evidence satisfactory to the Commissioner be found inadequate or excessive for the extinguishment of the fair market value of the timber as of March 1, 1913.[8]

Charges to Capital and to Expense in the Case of Timber. In the case of timber operations all expenditures for plant, equipment, development, rent and royalty prior to production, and thereafter all major items of plant and equipment, should be charged to capital account for purposes of depreciation. After a timber operation and plant has been developed and equipped to its normal and regular output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current expenses of operations.[9]

Depreciation of Improvements in the Case of Timber. The cost or value as of March 1, 1913, as the case may be, of development not represented by physical property having an inventory value, and such cost or value of all physical property which has not been deducted and allowed as expense in the returns of the taxpayer, is recoverable through depreciation. It is optional with the taxpayer, subject to the approval of the Commissioner, (a) whether the cost or value, as the case may be, of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or (b) whether the cost or value shall be recovered by appropriate charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. In no case may charges for depreciation be based on a rate which will extinguish the cost or value of the property prior to the termination of its useful life. The value of a timber plant and equipment, so far as it is represented by physical property having an inventory value, may not be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or

[8] Reg. 45, Art. 230.
[9] Reg. 45, Art. 231.

shall have been abandoned, and no part of the value of cut-over land is recoverable through depreciation.[10]

Statement to Be Attached to Return Where Depletion of Timber Claimed. To the return of the taxpayer claiming a deduction for depletion or depreciation or both there should be attached a statement setting out (a) whether the owner is an owner in fee or a lessee or both; (b) a description of the property owned in fee, if any, and a description of the leasehold property, if any, including the date of acquisition and the date of expiration of the lease; (c) the cost of the freehold and the leasehold property; (d) the number of feet of timber removed and sold during the year for which the return was made; (e) the total amount deducted on account of depletion and on account of depreciation, stated separately, up to the taxable year during the ownership of the taxpayer; and (f) any other data which would be helpful in determining the reasonableness of the depletion and depreciation deductions claimed in the return. The taxpayer should keep accurate ledger accounts, and in general should comply with the requirements of the chapters relating to the depletion of mines and oil and gas wells, so far as applicable.[11]

10 Reg. 45, Art. 232.

11 Reg. 45, Art. 233. See Chapters 28 and 29.

CHAPTER 31

NORMAL TAX CREDITS—PERSONAL EXEMPTION

Net income is ascertained by subtracting the allowable deductions from the gross income of the taxpayer. The net income so ascertained is subject to the surtax if the taxpayer is an individual, or to war-profits and excess-profits taxes if the taxpayer is a corporation, but for the purposes of the normal tax of individuals and the income tax of corporations, certain items of income may be credited against net income as above ascertained. These credits are: (a) such items of income as are included in gross income but are not subject to normal tax in the case of individuals or income tax in the case of corporations (i. e., dividends and interest on certain obligations of the United States); (b) the personal exemption and credit for dependents in the case of individuals and the amount of the war-profits and excess-profits taxes in the case of corporations plus $2,000 in the case of domestic corporations only.[1] A foreign corporation is allowed the same credits as a domestic corporation other than the sum of $2,000.[2]

Credit of Dividends. For the purpose of the normal tax only there may be credited against net income the amount received as dividends from a corporation taxable upon its net income and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed.[3] The dividends included in the above provision of law are those received from corporations other than foreign corporations having no income from sources within the United States.[4] In a late ruling it is held that the normal tax does not apply to dividends, regardless of the amount of such dividends, received from

1 Revenue Act of 1918, §§ 216, 236.

2 Reg. 45, Art. 591. For a discussion of the credit of war-profits and excess-profits taxes allowed to corporations see Chapter 10.

3 Revenue Act of 1918, § 216 (a). Such dividends when received by a corporation are an allowable *deduction*. (Revenue Act of 1918, § 234 (a) 6.)

4 Reg. 45, Art. 301.

a foreign corporation taxable upon income from sources within the United States, *however small such income may be.*[5]

Credit of Interest. The Revenue Act of 1918 provides that in the case of individuals for the purpose of the normal tax only there may be taken as a credit against net income the amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income.[6] In the case of corporations such amount may be taken as a credit against net income for purposes of income tax.[7] Consequently as to individuals, the normal tax does not apply to interest on any obligations of the United States and in the case of corporations no *income* tax is imposed on any interest received upon obligations of the United States or bonds of the War Finance Corporation.[8]

Personal and Specific Exemptions. It is provided that for the purpose of the normal tax there may be taken as a credit against net income in the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together will receive but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them.[9] In the case of domestic corporations only, there is allowed, for purposes of income tax, a specific credit of $2,000.[10] The personal exemption is allowed in all cases to citizens and residents; a non-resident alien may secure the personal exemption in certain cases and on certain conditions.[11] The personal exemption may be said to be an arbitrary sum allowed for personal, living and family expenses, which are not otherwise deductible.[12]

[5] Letter from Treasury Department dated June 9, 1919; I. T. S. 1919, ¶ 3427.

[6] Revenue Act of 1918, § 216 (b).

[7] Revenue Act of 1918, § 236 (a).

[8] Reg. 45, Arts. 301, 591.

[9] Revenue Act of 1918, § 216 (c).

[10] Revenue Act of 1918, § 236 (c).

[11] See p. 479.

[12] Such expenses are expressly stated not to be deductible in the Revenue Act of 1918. See Revenue Act of 1918, § 215 (a). See also Revenue Act of 1916, § 5 (a).

HEAD OF FAMILY. A head of a family is a person who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. The head of a family may be a single or married person, a widow, widower, brother, sister, or other relative by blood, marriage or adoption. In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the statute must depend on the character of the separation. If a father is absent on business or at war, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not the head of a family.[13]

HUSBAND AND WIFE. In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the statute must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together for the purpose of the statute, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption.[14]

[13] Reg. 45, Art. 302; T. D. 2427; T. D. 2692; Reg. 33 Rev., Art. 14.
[14] Reg. 45, Art. 303; T. D. 2692.

CREDIT FOR DEPENDENTS. A taxpayer receives a credit of $200 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under eighteen or (b) incapable of self-support because defective. The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.[15]

DATE DETERMINING EXEMPTION. The status of the taxpayer on the last day of his taxable year determines his right to an additional exemption and to a credit for dependents. If then he is the head of a family, the personal exemption of $2,000 may be taken. If then he is the chief support of a dependent who is under eighteen years of age or incapable of self-support because mentally or physically defective, the credit of $200 may be taken. But an unmarried individual or a married individual not living with husband or wife, who during the taxable year has ceased to be the head of a family or to have dependents, is entitled only to the personal exemption of $1,000 allowed a single person. A husband and wife living together at the end of the taxable year may receive but one personal exemption of $2,000, divisible as they please, against their aggregate net income. If an individual dies during the taxable year, his executor or administrator in making a return for him is entitled to claim his full personal exemption according to his status at the time of his death. If a husband or wife so dies and the joint personal exemption is used by the executor or administrator in making a return for the decedent, an undiminished personal exemption according to the status of the survivor at the end of the taxable year may be claimed in the survivor's return. If a taxpayer makes a return for a period other than a taxable year, the last day of such period is treated as the last day of the taxable year for the purposes of the above discussion.[16]

15 Revenue Act of 1918, § 216 (d); Reg. 45, Art. 304. Formerly this exemption was limited to dependent *children*.

16 Reg. 45, Art. 305. In the instructions appearing on the forms of individual returns for 1919 there first appeared a statement indicating that the personal exemption should be prorated if there was a change in the status of

Credits to Non-Resident Alien Individual. A non-resident alien individual, similarly to a citizen or resident, is entitled for the purpose of the normal tax to credit dividends from domestic or resident foreign corporations, interest on obligations of the United States, a personal exemption, and $200 for each dependent, except that if he is a citizen or subject of a country which imposes an income tax a personal exemption or credit for dependents is allowed him "only if such country allows a similar credit to citizens of the United States not residing in such country" or if no tax is levied on citizens of the United States not residing in such country on income from such country.[17] "If such country allows a similar credit" means if such country in imposing its income tax allows a personal exemption or a credit for dependents, as the case may be, and allows it without discrimination to citizens of the United States not residing in such country. "Country" includes within its meaning any foreign sovereign state or self-governing colony (for example, the Dominon of Canada), but does not include a foreign municipality (for example, Montreal) unless itself a sovereign state (for example, Hamburg).[18] To satisfy the requirement of a similar credit it is not necessary that the personal exemption or credit for dependents, as the case may be, should be the same as that allowed by the United States statute. The status as to residence of an alien individual on the last day of his taxable year determines his right to be treated as a resident or as a non-resident for such year.[19]

When Non-Resident Alien Individual Entitled to Personal Exemption. The following is an incomplete list of countries which either impose no income tax or in imposing an income tax allow both a personal exemption and a credit for dependents which satisfy the similar credit requirement of the statute: Argentina, Belgium, Bohemia, Bolivia, Bosnia, Brazil, Bukowina, Canada, Carinthia, Carniola, China, Chile, Cuba, Dalmatia, Denmark, Ecuador, Egypt, France, Galicia, Goritz, Gradisca, Herze-

the taxpayer during the year, but the Treasury Department receded from this position prior to March 15, 1919.

17 Letter from Treasury Department dated May 1, 1919; I. T. S. 1919, ¶ 3324.

18 Reg. 45, Art. 382.

19 Reg. 45, Art. 306.

govina, Istria, Lower Austria, Mexico, Montenegro, Moravia, Morocco, Newfoundland, Nicaragua, Norway, Panama, Paraguay, Persia, Peru, Portugal, Roumania, Russia (including Poles owing allegiance to Russia), Salzburg, Santo Domingo, Serbia, Siam, Silesia, Styria, Spain, Trieste, Tyrol, Upper Austria, Union of South Africa, Venezuela. The following is an incomplete list of countries which in imposing an income tax allow a personal exemption which satisfies the similar credit requirement of the statute, but do not allow a credit for dependents: Bachka, Banat of Temesvar, Croatia, Salvador, India, Italy, Slavonia, Slovakia, Transylvania. The following is an incomplete list of countries which in imposing an income tax do not allow to citizens of the United States not residing in such country either a personal exemption or a credit for dependents and, therefore, fail entirely to satisfy the similar credit requirement of the statute: Australia, Costa Rica, Great Britain and Ireland, Japan, The Netherlands, New Zealand, Sweden. The former names of certain of these territories are here used for convenience, in spite of an actual or possible change in name or sovereignty. A non-resident alien individual who is a citizen or subject of any country in the first list is entitled for the purpose of the normal tax to such credit for a personal exemption and for dependents as his family status may warrant. If he is a citizen or subject of any country in the second list he is entitled to a credit for personal exemption, but to none for dependents. If he is a citizen or subject of any country in the third list he is not entitled to credit for either a personal exemption or for dependents. If he is a citizen or subject of a country which is in none of the lists, then to secure credit for either a personal exemption or for dependents he must prove to the satisfaction of the Commissioner that his country does not impose an income tax or that in imposing an income tax it grants the similar credit required by the statute.[20]

Allowance of Credits to Non-Resident Alien Individual. The benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a non-resident alien by filing a claim with the withholding agent, but only by claiming them upon filing a return of income, with two exceptions as indicated in the two paragraphs next following.[21]

20 T. D. 2922.

21 Revenue Act of 1918, § 217; Reg. 45, Arts. 311 and 316.

PERSONAL EXEMPTION OF NON-RESIDENT ALIENS. In case a non-resident alien is entitled to personal exemption and credits for dependents and his gross income from sources in the United States, including bond interest, does not exceed his personal exemption and credits for dependents, a certificate, Form 1001B, should be executed and filed with the withholding agent, if any part of the gross income is derived from interest upon bonds of a domestic corporation which contain a tax-free covenant clause. The certificate may be filed with the withholding agent at the end of the calendar year but not later than February first of the succeeding year and all such certificates should be attached to the annual list return, Form 1013. The amount of tax due from the withholding agent as shown by Form 1013, may be reduced by 2% of the aggregate amount of interest payments made to the non-resident alien upon tax-free covenant bonds during the calendar year, and the amount of tax represented by the certificates, payment of which was assumed on monthly list return, Form 1012, will not be included in the assessment against the withholding agent. The certificate may be filed only by a citizen or subject of the countries enumerated in a preceding paragraph as satisfying the similar credit requirement of the statute. In case tax in excess of a non-resident alien's tax liability has been withheld from interest upon bonds which do not contain a tax-free covenant clause, the non-resident alien should file or cause to be filed with the collector a return of his gross income from all sources within the United States, accompanied by a claim for refund on Form 46.[22]

ALLOWANCE OF PERSONAL EXEMPTION TO NON-RESIDENT ALIEN EMPLOYEE. A non-resident alien employee, provided he is entitled to credit for a personal exemption or for dependents or both, may claim the benefit of such credit by filing with his employer Form 1115, duly filled out and executed under oath. On the filing of such claim the employer must examine it. If on such examination it appears that the claim is in due form, that it contains no statement which to the knowledge of the employer is untrue, that such employee on the face of the claim is entitled to credit, and that such credit has not yet been exhausted, such employer need not until such credit be in fact exhausted withhold any

[22] T. D. 2920.

tax from payments of salary or wages made to such employee. Every employer with whom affidavits of claim on Form 1115 are filed by employees must preserve such affidavits until the following calendar year, and must then file them, attached to his annual withholding return on Form 1042 (revised), with the collector on or before March 1. In case, however, when the following calendar year arrives such employer has no withholding to return, he must forward all such affidavits of claim directly to the Commissioner (Sorting Division), with a letter of transmittal, on or before March 15. Where any tax is withheld, the employer in every instance should show on the pay envelope or should furnish some other memorandum showing the name of the employee, the date and the amount withheld. This rule applies only to payments of compensation by an employer to an employee.[23]

[23] Reg. 45, Art. 316.

CHAPTER 32

CREDIT FOR TAXES

The Revenue Act of 1918 is the first American income tax law to recognize and provide against the double taxation of income of an individual or corporation deriving income from sources within the United States and another country. Heretofore, a citizen of the United States doing business, for example, in Canada has been taxed upon the net income arising from that business by Canada and upon the same net income by the United States. Under the present law a taxpayer in such a position will be allowed to deduct from the total tax found to be due on his entire net income the amount of tax paid to Canada on the income arising in that country. The privilege is extended to the following classes of taxpayers and to the extent indicated below.

Definition. "Amount of taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the taxpayer claiming credit. "Foreign country" includes within its meaning any foreign sovereign state or self-governing colony (for example, the Dominion of Canada), but does not include a foreign municipality (for example, Montreal) unless itself a sovereign State (for example, Hamburg). "Any possession of the United States" includes, among others, Porto Rico, the Philippines and the Virgin Islands.[1]

Citizens of the United States. In the case of a citizen of the United States, whether resident or non-resident, the basis of the credit for taxes is the amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any foreign country upon income derived from sources therein, or to any possession of the United States.[2]

Resident Aliens. In the case of an alien resident of the United States the basis of the credit for taxes is as follows: (a) the

[1] Reg. 45, Art. 382.

[2] Revenue Act of 1918, § 222 (a); Reg. 45, Art. 381.

amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any possession of the United States; (b) the amount of any such taxes paid or accrued during the taxable year to the country of which he is a citizen or subject upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.[3]

Non-Resident Aliens. No credit for taxes is allowed to a non-resident alien.[4]

Citizens of Possessions, Residing in the United States. Citizens of possessions of the United States residing in the United States are allowed a credit of any income, war-profits and excess-profits taxes paid during the taxable year to any possession of the United States.[5]

Domestic Corporations. In the case of a domestic corporation (one created or organized in the United States) the credit for taxes is the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States.[6]

Foreign Corporations. No credit for taxes is allowed to a foreign corporation notwithstanding that it may have established its principal business in this country.[7]

Domestic Corporations, Owning Stock of Foreign Corporations. A domestic corporation which owns a majority of the voting stock of a foreign corporation is entitled to credit its income, war-profits and excess-profits taxes with any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends (not deductible under Section 234 of the Law)[8] received by such domestic corporation from such foreign corporation

3 Revenue Act of 1918, § 222 (a) 2, 3; Reg. 45, Art. 381.

4 See Revenue Act of 1918, § 222.

5 Revenue Act of 1918, § 22 (a) 2; Reg. 45, Art. 1132.

6 Revenue Act of 1918, § 238; Reg. 45, Art. 611.

7 See Revenue Act of 1918, § 238.

8 See p. 152.

during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no case may the amount of the credit for such taxes exceed the amount of the dividends on the stock of the foreign corporation received by the domestic corporation during the taxable year (and not deductible under Section 234 of the Law). A domestic corporation seeking such credit must comply with the provisions of law applicable to credits for taxes already paid.[9]

Members of Partnerships. If an individual is a member of a partnership he is entitled to his proportionate share of any income, war-profits and excess-profits taxes paid or accrued during the taxable year by the partnership to any foreign country or to any possession of the United States. The law does not appear to make any distinction between domestic or foreign partnerships, but it has been ruled that if the member of a partnership is a resident alien he is entitled to the credit only "if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country."[10]

Beneficiaries of Estates or Trusts. Beneficiaries of estates or trusts are entitled to their proportionate shares of such taxes of the estate or trust paid during the taxable year to a foreign country or to any possession of the United States. If the beneficiary is a resident alien he is limited in the same manner as a resident alien member of a partnership.[11]

Conditions of Allowance of Credit. (a) When credit is sought for income, war-profits or excess-profits taxes paid other than to the United States, the income tax return of the taxpayer must be accompanied by a form,[12] carefully filled out with all the information there called for and with the calculations of credits there indicated, and duly signed and sworn to or affirmed. When credit is sought for taxes already paid the form must have attached to it the receipt for each such tax payment. When credit is sought for taxes accrued the form must have attached to it the return on which each such accrued tax was based. This receipt

9 Revenue Act of 1918, § 240; Reg. 45, Art. 636. In accordance with Reg. 45, Art. 611, the form to be used is Form 1118 instead of Form 1116.

10 Revenue Act of 1918, § 222; Reg. 45, Art. 381.

11 Revenue Act of 1918, § 222; Reg. 45, Art. 381.

12 Form 1116 for individuals or Form 1118 for corporations.

or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original or a duly certified or authenticated copy. (b) In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to the above form. If such a bond is required, the prescribed form[13] shall be used for it. It shall be in such penal sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, his agent or representative, as principal, and by sureties satisfactory to and approved by the Commissioner.[14]

Redetermination of Tax When Credit Proves Incorrect. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited against any income. war-profits or excess-profits taxes, or installment thereof, then due from such taxpayer under any other return, and any balance of such amount shall be immediately refunded to him.[15]

13 Form 1117 for individuals or Form 1119 for corporations.

14 Reg. 45, Art. 383; see also Art. 611 as to corporations. Domestic corporations claiming credit for taxes paid by a foreign subsidiary are permitted to avail themselves of subdivision (a) of this ruling, but not (b) as credit may be claimed only with respect to taxes paid (not those accrued) by foreign subsidiaries.

15 Revenue Act of 1918, §§ 222 (b), 252; Reg. 45, Art. 384.

CHAPTER 33

METHODS AND PERIODS OF ACCOUNTING

Net income must be computed with respect to a fixed period. Usually that period is the taxable year which is the time unit for the purpose of the tax.[1] It must also be computed with respect to a definite method of accounting. The Revenue Act of 1918 provides that net income shall be computed upon the basis of the taxpayer's *annual accounting period* (fiscal year or calendar year as the case may be), in accordance with the *method of accounting* regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation must be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no accounting period or does not keep books, the net income must be computed on the basis of the calendar year.[2] This provision extends to all taxpayers the privilege of reporting income upon the basis of book entries, a privilege accorded in some respects by the 1916 Law only to partnerships and corporations,[3] and at the same time changes the privilege into a requirement. Prior to its enactment an individual reported on the basis of the calendar year, whatever his particular period of accounting, and he usually reported only income actually or constructively received, as distinguished from income accrued, although his books might be kept on the basis of the fiscal year running, for instance, from July 1st to June 30th and upon the basis of accrued receipts and charges rather than ac-

1 Reg. 45, Arts. 22, 1533.

2 Revenue Act of 1918, § 212.

3 Revenue Act of 1916, §§ 8 (g), 13 (a), 13 (d). The privilege of reporting upon the basis of accrued receipts and charges was extended by §§ 8 (g) and 13 (d) to both individuals and corporations. The privilege of reporting upon the basis of a fiscal year was extended to corporations by § 13 (a).

tual receipts and disbursements. The provision of the 1918 Law is designed to secure returns of income upon the same basis as and in accord with the books of the reporting taxpayers whenever these books are kept in accordance with valid accounting practices. This change will facilitate both the preparation of returns by the taxpayer by lessening the necessity for readjustment and the verification of returns by Revenue Agents and Inspectors, who will henceforth be able to compare figures more readily.

Basis of Actual Receipts. In the case of many taxpayers the old basis of actual receipts and disbursements will be continued under the Revenue Act of 1918 as a basis for the computation of net income. Taxpayers who (a) employ no specific method of accounting in keeping their books, (b) employ a method of accounting which does not clearly reflect the income, or (c) keep their books upon the basis of actual receipts and disbursements, will compute their net income under the 1918 Law upon the basis of actual receipts and disbursements; that is, such taxpayers will report as gross income only items actually or constructively received in cash or its equivalent, and as deductions only items paid in cash or its equivalent.[4]

Reporting Income Upon Accrual Basis. The requirement that income be reported and deductions taken upon the accrual basis is confined to taxpayers who (a) keep books, and (b) employ a method of accounting clearly reflecting their income. If such taxpayers employ a method of accounting according to which items, both of income and liability, are set up when they accrue, or are incurred, they are required to use this method of accounting as a basis for their returns of income.

Reporting Deductions Upon Accrual Basis. It is to be noted that both receipts and liabilities must be entered upon the same basis if the income of a taxpayer is to be clearly reflected. When the accrual basis is used for the computation of net income, items of gross income and deductions are both accounted for upon the accrual basis. Unless all items of gross income and all deductions are treated with reasonable consistency, a method of accounting will not be regarded as clearly reflecting income.[5] The Revenue Act of 1918 uses the words "paid or incurred," or the

[4] Revenue Act of 1918, §§ 212 and 232.

[5] Reg. 45, Art. 23.

words "paid or accrued" in connection with many of the deductions specified and it is also provided that the term "paid" for the purpose of the deductions and credits allowed by the income tax means "paid or accrued" or "paid or incurred" and that the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which net income is computed.[6]

ACCRUED CHARGES. If book entries represent an actual expense or element of cost in the production of the income of the year, their amount is properly deductible, even though they have not been actually disbursed in cash or its equivalent, provided they constitute a liability against the assets of the taxpayer and provided further that the income is also returned upon an accrued basis. If in the course of its business, a corporation credits the accounts of individuals, firms or corporations with any expenses, interest, rentals, wages, etc., due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred are vouchered in definite amounts, and if the amounts so credited or vouchered are expenses incurred concurrently with and in the production of the income of the year, they may be deducted therefrom. The deduction of any accrued charges which if paid in cash or otherwise would not be deductible is not permitted.[7]

RESERVES TO MEET LIABILITIES. Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of the Interstate Commerce Commission or of any federal, state or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amounts of which, and the date of payment or maturity of which are not definitely determined or determinable at the time the liabilities are incurred, the amounts credited to such reserves were permitted to be deducted, under the 1916 Law, provided the amounts deductible on account of the reserves approximated, as nearly as could be determined, the actual amounts which experience had demonstrated would be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves were made. If it was found that the amount

6 Revenue Act of 1918, § 200.
7 Reg. 33 Rev.; Art. 126; T. D. 2433.

credited to any such reserve was in excess of the reasonable or probable needs for which the reserve was created, the excess would be disallowed as a deduction and restored to income.[8] In no event are sinking funds or other reserves set up to meet additions, betterments or other capital obligations allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., are not allowable as deductions, since such losses are only deductible when definitely determined as a result of a closed or completed transaction and actually charged off.[9]

Methods of Accounting. Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.[10] It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. Among the essentials are the following: (1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor inventories of the merchandise

8 The Treasury Department has always held, in the case of corporations, that it was immaterial whether deductions, except for taxes and losses, were evidenced by actual disbursements in cash, or evidenced in such other ways as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets, except that taxes were deductible only when actually paid, and not merely entered as a charge, and losses when actually sustained in the year charged off. But as to taxes, this rule seems to have been changed in the case of corporations electing under the 1916 Law to report according to their books, by the ruling that corporations which accrued on their books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, might deduct from their gross income the amount so accrued, provided such accruals approximated as nearly as possible the actual liabilities for which the accruals were made, and provided that in cases wherein deductions were made on the accrual basis, income from fixed and determinable sources accruing to the corporation was returned, on the same basis. (T. D. 2433.) Corporations keeping books of account on an accrual basis were permitted to deduct from gross income accrued interest for the year when shown as a charge against accrued income upon the corporate books of account. (T. D. 2625.)

9 T. D. 2433.

10 Reg. 45, Art. 23.

on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year; (2) expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and (3) in any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be charged against the property account or the appropriate reserve and not against current expenses.[11]

CONSOLIDATED RETURNS. A discussion of the subject of the filing of consolidated returns by affiliated corporations and the computation and determination of the tax of such corporations upon the basis of such returns will be found in another chapter.[12]

WHEN ITEMS SHOULD BE REPORTED. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation must be made in such manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.[13] All items of gross income must be included in gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. For the taxable year 1918 the true income, computed under the Revenue Act of 1918 and—where the taxpayer keeps books of account—in accordance with the method of accounting regularly

11 Reg. 45, Art. 24.

12 See Chapter 10.

13 Revenue Act of 1918, § 213 (a); Reg. 45, Art. 221.

employed in keeping such books, must in all cases be entered in the return, even though this results in apparent omissions or duplications of particular items of income or expense. In the ordinary case such omissions and duplications are more apparent than real and are likely to counterbalance one another so that the change in the basis of reporting calls for no material adjustment. Where, however, the method previously employed by the taxpayer in determining his income subject to the tax, is materially different from the method regularly used by the taxpayer in keeping his accounts, or where for any reason the basis of reporting income subject to tax is changed the taxpayer should attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change. Where, for example, a taxpayer who, prior to 1918, has reported on the so-called receipts basis, is compelled under the above rule to report on the so-called accrual basis, he should include in the separate statement the following information: *First* (a) expenses paid before the end of the taxable year 1917 but not accrued at that date; (b) income accrued at the end of the taxable year 1917 but not received at that date; (c) expenses accrued at the end of the taxable year 1917 but not paid at that date; (d) income received before the end of the taxable year 1917 but not accrued at that date; and *Second,* similar items as of the end of the taxable year 1916. If in the opinion of the Commissioner such information indicates that the returns for any previous years did not reflect the true income, amended returns for such years will be required.[14]

BANK DISCOUNTS. Banks which in the past have treated discount as income before it was actually earned and through the taxable year 1918 have placed discount account upon an accrual basis will be required to submit the information called for in (2) of the preceding paragraph and submit an amended return for the taxable year 1917 and will be permitted to submit (or the Commissioner may require) amended returns for all prior years during which the taxpayer was subject to tax. Additional taxes for prior years found to be due upon such re-examination will be

14 Reg. 45, Article 23 as amended by T. D. 2873.

paid upon the basis of the amended returns in the ordinary way. Where it appears that prior taxes have been paid in excess of the amount properly due such excess will to the extent possible be credited against future income and profits taxes.[15]

CHANGING BASIS FOR COMPUTATION OF NET INCOME. If a taxpayer should change the method of accounting employed in keeping his books for the taxable year 1919 or thereafter, he must before computing his income upon such new basis for purposes of taxation secure the consent of the Commissioner. Application for permission to change the basis of the return must be made at least thirty days in advance of the date of filing return and must be accompanied by statement specifying the class of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change.[16]

Accounting Period: Fiscal Year. The return of a taxpayer is made and his income computed for his taxable year as a time unit, which means his fiscal year, or the calendar year if he has not established a fiscal year.[17] The term fiscal year means an accounting period of twelve months ending on the last day of any month other than December.[18] No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith.[19] A taxpayer having an existing accounting period which is a fiscal year within the meaning of the statute not only needs no permission to make his return on the basis of such a taxable year, but is required to do so, regardless of the former basis of rendering returns. A person having no such fiscal year must make return on the basis of the calendar year. Except in the cases of a return for the taxable year 1918 and of a first return for income tax, a taxpayer makes

15 T. D. 2873.

16 Revenue Act of 1918, § 212. Reg. 45, Art. 23, as amended by T. D. 2873.

17 Reg. 45, Art. 25. The taxable year 1919 is the calendar year 1919 or any fiscal year ending during the calendar year 1919.

18 Revenue Act of 1918, § 200. No return received for a period ending on any date other than the last day of some month will be accepted, unless it is a "final return" and made to the day the corporation ceased business. (Mimeograph letter to collectors, No. 1148.)

19 Reg. 45, Art. 25.

his return on the basis (fiscal or calendar year) upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed the basis of computing his net income.[20]

FIRST RETURNS. The Revenue Act of 1918 provides that "if a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year."[21] The first return under the present statute of a taxpayer who theretofore made returns on a basis different from his accounting period will necessarily overlap his next previous return.

CHANGE IN ACCOUNTING PERIOD. If a taxpayer changes his accounting period, and not merely his taxable year to conform with his existing accounting period, he must as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given at a time which is both (a) at least thirty days before the due date of the taxpayer's return on the basis of his existing taxable year and (b) at least thirty days before the due date of his return on the basis of the proposed taxable year. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer will thereafter make his returns upon the basis of the new accounting period in accordance with the requirements of the statute discussed elsewhere.[22]

FISCAL YEAR OF CORPORATION OR INDIVIDUAL ENDING IN 1919. The method provided for computing the tax for a fiscal year beginning in 1918 and ending in 1919 is as follows: (a) the tax attributable to the calendar year 1918 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as if the fiscal year was the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full

20 Reg. 45, Art. 25.

21 Revenue Act of 1918, §§ 226 and 232; Reg. 45, Art. 25. The method of adjusting the tax in such case is discussed in Reg. 45, Arts. 1621-4. § 205 of the Statute is applicable; § 226 has no application.

22 Reg. 45, Art. 26. See Chapter 34.

fiscal year; (b) the tax attributable to the calendar year 1919 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as if the fiscal year was the calendar year 1919, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; and (c) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1918 and the tax attributable to the calendar year 1919.[23]

FISCAL YEAR OF PARTNERSHIPS. This subject is discussed in the chapter on partnerships.

[23] Reg. 45, Art. 1625. For the rules as to fiscal years of corporations and individuals beginning in 1917 and ending in 1918 and deductions and credits in the case of corporation with a fiscal year ending in 1918 see Reg. 45, Arts. 1621, 1622, 1623, 1624.

CHAPTER 34

RETURNS OF INCOME

For the purpose of assessing the tax, a return of income is required, showing specifically the items of gross income and the deductions and credits allowed by law. This chapter deals with the general provisions relating to returns of income, and does not cover the annual or special returns required with respect to withholding at the source, information at the source or other matters. For a discussion of such returns attention is directed to chapters on the respective subjects.

By Whom Filed. The law requires a return of income to be filed by every individual having a net income for the taxable year of $1,000 or over, if single or if married and not living with husband or wife, or of $2,000 or over, if married and living with husband or wife.[1] A return is required of every fiduciary[2] (with the exception of receivers appointed by authority of law in possession of part only of the property of an individual) or at least one of joint fiduciaries for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or $2,000 as indicated above or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a non-resident alien.[3] Minors are expressly required to make returns. The return of an incompetent must be filed for him by his committee. A return is required from every partnership and from every corporation and personal service corporation subject to the tax regardless of whether or not they have been in receipt of any income during the taxable year.[4]

Individual Returns. Every individual whose net income as defined in the statute is $1,000 or over for the taxable year must

1 Revenue Act of 1918, § 223.

2 See Chapter 6 for a definition of the term "fiduciary."

3 Revenue Act of 1918, § 225, Reg. 45, Art. 421.

4 Revenue Act of 1918, §§ 224 and 239.

make a return of income unless married and living with husband or wife, in which case a return must be made if the net income is over $2,000. Individuals having less than the above amounts of income may be required to make returns or statements sufficient to satisfy the Commissioner that they are not liable to tax.[5] The return must be for the taxable year, whether calendar or fiscal. Whether or not an individual is the head of a family or has dependents is immaterial in determining his liability to render a return.[6] The individual return is made on Form 1040 (revised), except that it may be on Short Form 1040a (revised) where the net income does not exceed $5,000 and the net income subject to the normal tax, that is, after applying the personal exemption and other credits, does not exceed $4,000. The forms are provided by the Commissioner and may be had from the collectors of the several districts.

HUSBAND AND WIFE. A husband and wife living together may make a single joint return. If a husband and wife, living together, have separate estates, the income from both may be reported in one return, but the amount of income of each, and the full name and address of both, must be shown in such return. Ordinarily, the husband, as the head and legal representative of the household, and general custodian of its income, should make the return of the aggregate income of himself and his wife. Unless the wife files a separate return of income or joins with her husband in a return which sets forth her income separately, her husband should include in his return the income accruing to the wife from services rendered by her or the sale of products of her labor. If, however, the wife does not disclose her income to the husband, each may make a return, in which case the personal exemption may be divided between the two in such proportions as they agree upon. If either husband or wife separately has an income equal to or in excess of $2,000 a return is required under the law. If the aggregate income of both is $2,000 or more, the Treasury Department requires a return, although neither may have an income of $2,000.[7] Where husband and wife file separate returns of income, one of them being filed in time and the other delinquent, such returns are not supplemental of each other and

5 Revenue Act of 1918, § 1305.

6 Revenue Act of 1918, § 223; Reg. 45, Art. 401.

7 Reg. 45, Arts. 401, 305.

delinquency must be answered for by the one in connection with whose return it occurred.[8]

MINORS. An individual under 21 years of age or under the statutory age of majority where he lives, whatever it may be, is required to render a return of income if he has a net income of his own of $1,000 or over for the taxable year. The Treasury Department treats a married minor as an adult for income tax purposes. If the aggregate of the net income of a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from any earnings for his own use, is at least $1,000, a return as in the case of any other individual must be made by him, or by his guardian, or by some other person charged with the care of his person or property for him. If, however, a minor is dependent upon his parent, who appropriates or may appropriate his earnings, such earnings are income of the parent and not of the minor for the purpose of the normal tax and surtax. In the absence of proof to the contrary a parent will be assumed not to have emancipated his minor child and must include in his return any earnings of the minor.[9]

8 Reg. 33 Rev., Art. 26.

9 Reg. 45, Arts. 403, 422. At common law, the age at which an infant male or female reaches full majority is twenty-one years. This rule is still almost universal by statute in the case of males but in Arkansas, California, Colorado, Idaho, Illinois, Iowa, Kansas, Maryland, Minnesota, Missouri, Nebraska, Nevada, North Dakota, Ohio, Oregon, South Dakota, Vermont, and Washington the age of majority as to females at least for some purposes, has been fixed at eighteen years. Married infants, male or female, are considered adults, whatever their age, in Iowa, Texas and Louisiana. Married female infants are considered adults, whatever their age, in Maryland, Oregon and Texas, and in Alabama if over eighteen and Nebraska if over sixteen years of age. A married female infant is considered an adult in Washington, whatever her age, provided her husband has attained his legal majority. Emancipation is not an exact term. (Dunke v. Grey, 3 Fed. 862, 865.) It is to be determined upon the peculiar facts and circumstances of each case and is never presumed (Brosius v. Barker, 154 Mo. App. 657; 136 S. W. 19). Emancipation is the relinquishment by the parent of control and authority over his child, conferring on the child the right to his earnings and extinguishing the parents' legal duty of support. (Rounds Bros. v. McDaniel, 133 Ky. 669; 118 S. W. 956, 958.) Emancipation may be complete or incomplete. Complete emancipation is an entire surrender of all the rights to the care, custody and earnings of the child, as well as a renunciation of parental duties, and the test to be applied is the preservation or destruction of the parental and filial relationship. (Brosius v. Barker, Supra.) Emancipation may also be express or implied: It

INCOMPETENTS. A fiduciary acting as the committee of an insane person having an income of $1,000 or $2,000, according to the marital status of such person, must make a return for such incompetent on Form 1040 (revised) or 1040A (revised), according to the amount of net income, and pay the tax.[10]

AGENTS. The Revenue Act of 1918 provides that if a taxpayer is unable to make his own return, the return shall be made by a duly authorized agent, or by the guardian or other person charged with the care of the person or property of such taxpayer.[11] If the return is made by the agent, the reason therefor must be stated.[12] If the return is made by an agent, when by reason of illness, absence or non-residence the person liable for the return is unable to make it, the agent assumes the responsibility for making the return and incurs liability to the specific penalties provided for erroneous, false or fraudulent returns.[13] There may be a fiduciary relationship between an agent and the principal, but the word "agent" does not denote a "fiduciary" for purposes of the income tax.[14] Unless otherwise provided, therefore, the principal and not the agent is subject to the liability under the law.[15] Notice of failure to make return may be served upon an agent. Upon such notice the agent will be permitted to

is express when the parent voluntarily agrees with the child, who is able to take care of and provide for himself, that he may go from home, earn his own living, and control his earnings, or when the father voluntarily transfers the custody and keeping of the child to another. An express emancipation cannot be renounced by the parent. An implied emancipation results where the parent by his acts or conduct, impliedly consents that the minor may leave home and shift for himself; the father, under these circumstances, however, being authorized to renounce the same within a reasonable time. (Rounds Bros. v. McDaniel, Supra.) Living separately from the family does not necessarily establish a child's emancipation. (Sherburne v. Hartland, 37 Vt. 528.) The better rule is that an infant husband is entitled to his own wages so far as they are necessary to the support of his wife and children, even though he married without the consent of his father. (Commonwealth v. Graham, 157 Mass. 73. See also: Bristor v. Chicago & N. W. Ry. Co., 128 Iowa, 479 N. W. 487; Alexandria v. Bethlehem, 16 N. J. L. 119; In re. Dunavant 96 Fed. 542.)

10 Reg. 45, Art. 422.

11 Revenue Act of 1918, § 223.

12 See Form 1040.

13 Reg. 45, Art. 402.

14 Reg. 33 Rev., Art. 29.

15 T. D. 2137.

file evidence with the collector showing that the individual for whom he acts did not receive taxable income during the year, or that the agent filed the return with some other collector, as provided by law.[16]

Corporation, Fiduciary and Partnership Returns. The subject of returns by corporations, including the new provisions regarding consolidated returns by affiliated corporations and the subject of returns by partnerships and fiduciaries are discussed in previous chapters.[17]

Where Returns Are Filed. Returns of income must be delivered or mailed to the collector for the district of the legal residence or principal place of business of the person making the return. Persons having no domicile or place of business in the United States, and persons in the military or naval service of the United States, may file their returns of income with the collector at Baltimore.[18] Although the law permits the return to be filed in either one of the two districts indicated above, the Treasury Department desires, for administrative purposes, that the return be filed in the district in which the individual resides.[19]

When Filed. Returns of income must be made on or before the fifteenth day of March following the taxable year, except that returns on the basis of a fiscal year other than the calendar year must be made on or before the fifteenth day of the third month following the close of the fiscal year.[20] The dates above indicated will be the primary due dates for all returns of income. Unless an extension of time is obtained, the taxpayer will be held delinquent if his return is not filed on or before the primary date and will be subject to the 25% additional tax and the penalties

16 Reg. 33, Art. 18.

17 See Chapters 10, 8 and 6.

18 Revenue Act of 1918, § 227; Reg. 45, Art. 448.

19 Letter from Treasury Department dated December 17, 1914; I. T. S. 1918, ¶ 596. The Treasury Department recognizes that the individual has the right to choose one of two districts, where he resides in one and does business in another, and the filing in either district will be a proper compliance with the law. For the year 1913 the Treasury Department requested the filing of returns in the district in which the individual's principal place of business was located. This threw an undue burden on the Collectors in large cities and the subsequent ruling was made in order to remedy this condition.

20 Revenue Act of 1918, § 227; Reg. 45, Art. 441.

provided by the law.[21] The rule in regard to the time for filing returns upon the death of a taxpayer or the termination of a trust is set forth elsewhere.[22]

LAST DUE DATE. These words are used to designate the last day upon which a return is required to be filed in accordance with the provisions of the law, or the last day of the period covered by an extension of time granted by the collector or Commissioner.[23] When the last due date as above defined falls on a Sunday or a legal holiday, the last due date will be considered the day next following, and the return should be filed not later than such following day, or, if placed in the mails, it should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return as here indicated is required to be filed.[24]

MAILING RETURNS. If a return is placed in the mails in due course properly addressed and postage paid, in ample time to reach the office of the collector on or before the last due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. Where a question may be raised as to whether or not the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return.[25]

Returns When Accounting Period Changed. No return can be made for a period of more than twelve months. A separate return for a fractional part of a year is, therefore, required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income, from one taxable year to another taxable year or wherever a taxpayer making his first return of income does so on the basis of a fiscal year.[26] If the change is from calendar year to fiscal year, a separate return must be made for the period between the close of the calendar year for which return was made and the date designated as the close of the fiscal

21 T. D. 2001; Reg. 45, Art. 441.
22 See Reg. 45, Art. 442. See Chapter 6.
23 Reg. 45, Art. 447; Reg. 33 Rev., Art. 218.
24 Reg. 45, Art. 447; Reg. 33 Rev., Art. 219.
25 Reg. 45, Art. 447; Reg. 33 Rev., Art. 52.
26 Revenue Act of 1918, § 226; Reg. 45, Art. 431.

year. If the change is from one fiscal year to another fiscal year, a separate return must be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If the taxpayer making his first return keeps his accounts on the basis of a fiscal year, he must make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year.[27] The requirements with respect to the filing of a separate return and the payment of tax for a part of a year, are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time.[28]

Extension of Time. The Revenue Act of 1918 makes provision in certain cases for an extension of time for filing returns. As indicated in the following paragraphs, such extensions may be granted by collectors or by the Commissioner.

Extension of Time by Collector. It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence, collectors are authorized to grant an extension of not exceeding thirty days where, in their judgment, such further time is actually required for the making of an accurate return.[29] The application for such extension must be made prior to the expiration of the period for which the extension is required. Absence or sickness of one or more officers of a corporation at the time the return is required to be filed, will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and sufficiently informed as to the affairs of the corporation to make and verify the return. As a condition of granting an extension of time for filing a return the collector may require the submission of a tentative return and estimate of the tax on Form 1040 T in the case of individuals, or on Form 1031 T in the case of corporations, and the payment of one-fourth of the estimated amount of tax.[30] Where a taxpayer has filed a tentative return and has failed to file a com-

27 Revenue Act of 1918, § 226.

28 Revenue Act of 1918, §§ 226 and 239; Reg. 45, Art. 431.

29 Revised Statutes § 3176, as amended by the Revenue Act of 1918, § 1317. Reg. 45, Art. 443.

30 Reg. 45, Art. 443.

plete return within the period of the extension requested by him the complete return when filed is subject to penalties prescribed for delinquency. Where a tentative return has been filed and no time has been fixed within which a complete return must be filed, the collector may at any time send notice to the taxpayer to file a complete return within a period of time therein specified by him, and a taxpayer who fails to comply with such request will incur the penalties prescribed by statute for delinquency in filing a return.[31]

EXTENSION OF TIME BY COMMISSIONER. In addition to the limited extension of thirty days which may be granted by collectors, the Commissioner may grant a reasonable extension of time for filing returns whenever, in his judgment, good cause exists. He is required to keep a record of such extensions and the reasons therefor. Except in the case of taxpayers who are abroad, no such extension may be for more than six months.[32] If, before the end of a thirty day extension granted by a collector, an accurate return cannot be made, an appeal for a further extension must be made to the Commissioner with a full recital of the causes for the delay. The Commissioner will not grant an additional extension without a clear showing that a complete return cannot be made before the end of the thirty day period. The Commissioner will grant no such extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return as complete as possible and giving a ground for assessment of the tax, must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return cannot be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. In exceptional circumstances the taxpayer may apply originally to the Commissioner for an extension of time.[33]

EXTENSION OF TIME IN THE CASE OF PERSONS ABROAD. In view of the disturbed conditions abroad and the consequent interference with the usual channels of communication, an extension of time for filing returns of income for 1918 and subsequent years

31 T. D. 2935.

32 Revenue Act of 1918, § 227 (a); Reg. 45, Art. 445.

33 Reg. 45, Art. 444.

and for paying the tax has been granted in the case of non-resident alien individuals and non-resident foreign corporations, or their proper representatives in the United States, and of American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States, for such period as may be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany. The installments of tax which are actually due must be paid at the time of filing the return and the other installments must be paid as they fall due. In all such cases an affidavit must be attached to the return, stating the causes of the delay in filing it, in order that the Commissioner may determine that the failure to file the return in time was due to a reasonable cause and not to wilful neglect and that the return was filed without any unnecessary delay. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty will be imposed. This extension is granted as a matter of general expediency to all persons abroad owing income, war profits, and excess-profits taxes to the Federal Government and is not granted upon the request of any particular taxpayer. Accordingly, in the case of taxpayers who take advantage of this general extension of time for the filing of returns and the payment of tax no interest will be collected from such taxpayers, but where a request is made by a taxpayer and an extension is granted for other reasons by the Commissioner, interest will be collected at the rate of one half of one per centum per month from the time the tax would have been due if no extension had been granted. This extension also applies to domestic corporations whose records are kept and business transacted abroad.[34]

EXTENSION OF TIME TO ENEMIES. An extension of time has been granted for such period as may be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany, for filing returns of income for 1918 and subsequent years and for paying the tax by or for non-resident enemies or allies of enemies, as defined by section 2 of the Trading with the Enemy Act of October 6, 1917, not holding licenses granted under the provisions of that act. The whole tax shown to be due must be paid at the time of filing the return. This exten-

[34] Reg. 45, Art. 445, as amended by T. D. 2844; telegram from Treasury Department dated April 19, 1919; I. T. S. 1919, ¶ 3312.

sion, however, does not authorize any delay in filing returns of information. This extension is also subject to the condition that all persons who on October 6, 1917, have, or since have had, or may hereafter have control of any money or other property for any such enemy or ally of enemy, or who, on October 6, 1917, were, or since have been, or may hereafter be indebted to any such enemy or ally of enemy, shall hold and deliver all such money and property in all respects subject to the Trading with the Enemy Act, and to the orders of the President and the Alien Property Custodian thereunder, and shall in due course file returns of income in respect of all such money and property for such period as may elapse or have elapsed prior to the actual delivery of such money and property to the Alien Property Custodian.[35] In other words, if delivery was made in November, 1917, a return should be filed for the portion of the year 1917 elapsing before such delivery, and if delivery was in March, 1918, a return should be filed for the year 1917 and also before March 1, 1919 for such portion of the year 1918 as elapsed before such delivery.[36]

TENTATIVE RETURNS. Prior to the passage of the 1916 Law, extension of time could be granted only in case of sickness or absence, but the Treasury Department permitted foreign corporations and domestic corporations doing business in foreign countries who were unable to assemble their data on or before the primary due date, to file tentative returns, approximating as nearly as possible the actual business transacted during the year. Such tentative returns were accepted subject to the substitution later of true and correct returns when the necessary data to make the same had been received.[37] Under the 1916 Law the Commissioner had authority to grant unlimited extension in meritorious cases, thus making unnecessary the filing of tentative returns.[38] Under the present law the Commissioner will grant no extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return as complete as possible, and giving the ground for assessment of the tax must be submitted on or before the due date as extended, and the tax shown to be due

35 Reg. 45, Art. 446; T. D. 2673.
36 Letter from Treasury Department dated May 3, 1918; I. T. S. 1919, ¶ 1515
37 T. D. 2137.
38 T. D. 2561 and T. D. 2581.

must be paid with the submission of the return. If a complete return cannot be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted.[39] A collector, in granting an extension of time, may also require the submission of a tentative return and payment of one-fourth of the estimated amount of tax.[40]

Forms. The forms on which the returns of income are to be made are prescribed by the Commissioner ,and may be had from the collectors of the several districts. The forms have been changed from time to time and those for 1918 contained much new matter. The forms for use by individuals are Form 1040 (revised) and Form 1040A (revised). The form prescribed for use by non-resident aliens is Form 1040 C., whether it is filed by the principal or by an agent on his behalf. Separate forms are provided for use by fiduciaries in cases where the tax is payable by the beneficiaries. In such case the form prescribed is Form 1041 (revised). A receiver in charge of the business of a partnership will render return on Form 1065 (revised). In other cases returns by fiduciaries are made on Form 1040 (revised) except that it may be on short Form 1040A (revised), where the net income does not exceed five thousand dollars. Partnerships make their returns on Form 1065 (revised). Corporations, whether domestic or foreign, make their returns on Form 1020. Form A Revised (mining), Form N (oil and gas), and Form T (timber) are available for taxpayers engaged in the mining, oil or gas, or timber industries.[41] These forms are prescribed to facilitate the compilation and presentation of certain information required for the audit and examination of the returns of these classes of taxpayers. If, however, it is more convenient to use other methods of tabulation, the information so furnished if complete will be accepted in lieu of these forms. The information called for by these forms should be filed with the returns in complete detail, either on the forms prescribed or in other suitable manner. This is necessary for the reason that depletion sustained must be taken into consideration in the computation of invested capital, regardless of whether or not a de-

39 Reg. 45, Art. 443.

40 Reg. 45, Art. 444.

41 A copy of Forms A, N, and T will be found in the appendix.

duction for it was claimed or has been claimed for it in the past by the taxpayer. This requirement applies to individuals as well as corporate taxpayers.[42]

USE OF PRESCRIBED FORMS. Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. Failure on the part of any taxpayer to receive a blank form will not, however, excuse him from making a return. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified and filed with the collector on or before the last due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form.[43]

Verification of Returns. All income tax returns must be verified under oath or affirmation before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the state or territory where such officer resides.[44] The affidavit may be made before the collector of the district or before any officer authorized by law to administer oaths.[45] Revenue agents, inspectors and special employees,[46] or any clerk in the office of the collector,[47] may, if commissioned as deputy collectors, take the oath of taxpayers. If a return is executed before a notary in a state where the law does not require the notary to use a seal, and none is used, a certificate of a clerk of court or other officer possessing a seal, showing that the notary

[42] T. D. 2849.

[43] Reg. 45, Art. 407.

[44] Reg. 45, Art. 406, as amended by T. D. 2951. Under this regulation a commissioner of deeds is authorized to administer an oath to an income tax return. T. D. 2952; See U. S. v. Benowitz, U. S. Dist. Ct. So. Dist. of N. Y. decided October 20, 1919; I. T. S. 1919, ¶ 3647.

[45] Reg. 33, Art. 22.

[46] T. D. 2235, T. D. 2238.

[47] T. D. 2293.

is duly commissioned and authorized to administer oaths, should be filed with the Commissioner; otherwise the return will not be accepted,[48] unless, as may be done, the collector waives this requirement in states where jurats are accepted in the state courts either with or without a seal, and without a certificate showing authority.[49]

VERIFICATION ABROAD. An individual residing abroad may acknowledge his return before any duly appointed officer of the country in which he resides, authorized to administer oaths and use an official seal.[50] Where a foreign notary or other official having no seal acts as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer. Income tax returns executed abroad may be attested free of charge before United States consular officers.[51]

VERIFICATION IN ARMY AND NAVY. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those services.[52]

Assistance by Collectors. Any assistance or information which may be needed in connection with the preparing and filing of income tax returns, is required to be furnished by the collector upon request. Questions regarding the tax will be answered upon inquiry at the Internal Revenue offices. When questions are directed to the Treasury Department at Washington asking for information which should be supplied by collectors, the letters are referred to the collectors for reply and the writers are advised accordingly.[53]

Return Made by Collector. The Revenue Act of 1918 provides that if any taxpayer fails to make and file a return or list at the time prescribed by law or by regulation made under authority of the law, or makes, wilfully or otherwise, a false or fraudulent return or list, the collector or deputy collector must make the return

48 T. D. 2090.
49 T. D. 2174.
50 T. D. 2090.
51 Reg. 45, Art. 406.
52 Reg. 45; Art. 406; T. D. 2534.
53 T. D. 1949; T. D. 1956.

or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, will be *prima facie* good and sufficient for all legal purposes.[54]

Erroneous Returns. Under previous laws, if a return was improperly prepared, it was returned by the collector to the taxpayer for correction, and the corrected return was accepted without penalty, provided the incorrect return showing the date of its receipt accompanied the corrected return.[55] The latest ruling under the present law states that an imperfect or incorrect return will not be accepted as meeting the requirements of the statute.[56]

Understatement in Returns. The Revenue Act of 1918 provides that if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he is required to give due notice to the taxpayer making the return to show cause why the amount shown by the return should not be increased and upon proof that the amount was understated, he may increase the same accordingly. Such taxpayers may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector, may appeal to the Commissioner for his decision under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary. If a collector suspects that the amount of any income is understated in a return, he may on his own initiative take up the matter with the taxpayer and upon being satisfied that the amount was understated, may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner. The Commissioner, however, without the intervention of the collector, may exercise original jurisdiction in cases of understatements or other errors in returns.[57]

54 R. S. § 3176 as amended by § 1317 of Revenue Act of 1918.

55 Mimeograph letter to Collectors dated February 9, 1915; I. T. S. 1919, ¶ 1541.

56 Reg. 45, Art. 407.

57 Revenue Act of 1918, § 228; Reg. 45, Art. 451.

Amended Returns. Where upon an audit of a return of an individual, a fiduciary, or a withholding agent, or as a result of an investigation made by a revenue agent, an additional tax is assessed, it is not necessary to file an amended return. Notice of the additional assessment will be given to the taxpayer by letter from the Treasury Department.[58] If a taxpayer discovers or detects expenses or liabilities which were due and payable during a preceding year, it is permissible for him to make an amended return for the year to which such expense or liability applies, include such expense in the deductions of that year, and file a claim for refund for any taxes overpaid by reason of the failure to deduct such expenses or liabilities in the original return of that year.[59] Where a corporation is called upon by a revenue inspector to make amended returns, the officers of the corporation will be given the fullest opportunity to make any investigation they may desire prior to signing such amended returns, provided, of course, such investigation does not cover an unreasonable length of time.[60]

Notice of Failure to File Returns. The Revenue Act of 1918 provides that whenever in the judgment of the Commissioner necessary, he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.[61]

58 Mimeograph letter No. 1232 to Collectors; Reg. 33 Rev., Art. 38.

59 Reg. 33 Rev., Art. 128; Reg. 45, Art. 23.

60 Letter from Treasury Department dated February 2, 1915; I. T. S. 1919, ¶ 1543. In 1915 and 1916 it was the practice of the Treasury Department to send out a letter to corporations whenever items on the return were reached, concerning which more detailed information was sought, referring to the return and briefly requesting information regarding one or more items therein. The letter ended with a statement that in the absence of an explanatory affidavit, at the end of thirty days from the date of the letter, the entire amount of the deductions questioned would be suspended and an assessment returned accordingly. (I. T. S. 1917, Par. 1623.)

61 Revenue Act of 1918, § 1305. Under the 1916 Law, when the collector possessed any information which led him to believe that any person in his district was in receipt of income for the year and did not make a return, he was required to serve a notice calling attention to the failure and to the fact that penalties for failure had been incurred. The notice also called attention to the fact that if the return was not filed within ten days from the date thereof, the books and papers of the taxpayer would be examined and a return prepared therefrom as provided by law. (Reg. 33, Art. 196.) This notice was

Inspection of Returns by the Public. The income tax law is specific and mandatory in the matter of safeguarding from publicity the information acquired by reason of its requirements relative to annual returns of income. The law imposes on collectors, deputy collectors, agents, clerks, or other officers or employees of the Bureau of Internal Revenue, including internal revenue agents, a penalty of fine, imprisonment, dismissal from office and forfeiture of right to hold office, for making known in any manner not provided by the law, the amount or source of income, or any particulars thereof, set forth or disclosed in a return of income by any person.[62] All internal revenue officers are cautioned to preserve as confidential all income tax returns.[63] The returns on which assessments have been made are filed in the office of the Commissioner and constitute public records and are open to inspection as such, but only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President.[64] It was held that a similar provision of the 1909 Law permitting the inspection of returns was not unconstitutional.[65] Pursuant to a similar provision of the 1913 Law, under date of July 28, 1914, the President issued an executive order, that returns should be subject to inspection in accordance with certain rules and regulations prescribed by the Secretary of the Treasury of the same date.[66]

Returns Must Be Inspected at Washington. Returns may be inspected by the public only in the office of the Commissioner in Washington. No collector or any other internal revenue officer outside of the Treasury Department in Washington is authorized to permit the inspection of any return, or to furnish any information whatsoever relative to any return, or any information secured by him in his official capacity relating to such return. No provision is made in the law for furnishing a copy of any return

sent out on Form 1045. For the first year of the income tax, March 1 to December 31, 1913, the collector sent out an informal letter as a preliminary to the formal notice. This letter invited the taxpayer to make a return without penalty within ten days but the letter was not used in subsequent years.

62 R. S. § 3167, as amended by the Revenue Act of 1918; Reg. 33 Rev., Art. 229; T. D. 2903.

63 T. D. 2135, T. D. 1962.

64 Revenue Act of 1918, § 257.

65 Flint v. Stone Tracy Co., 220 U. S. 107.

66 T. D. 2016. See Reg. 45, Art. 1091.

to any person or corporation and no copy will be furnished to any other than the person or corporation making the return, or their duly constituted attorney, except in the case where copies are furnished to officers of the Department of Justice for use in suits. A person having the privilege of inspection may make a copy or take notes for his own or an authorized use.[67]

RETURNS OF INDIVIDUALS. Returns of individuals are not open to the inspection of any person other than the proper officers and employees of the Treasury Department and the person who made the return or his duly authorized attorney. They are under no conditions made public, except where such publicity results through the use of such returns in any legal proceeding in which the United States is a party.[68]

RETURNS OF FIDUCIARIES. An executor acts for his principal and not for the beneficiaries of the estate of his principal. Beneficiaries of an estate or trust are not entitled, as such, to an inspection of returns of income filed by the fiduciary.[69]

RETURNS OF CORPORATIONS. The Secretary of the Treasury, at his discretion, upon application to him, setting forth what constitutes a proper showing of cause, may permit the inspection of the return of any corporation by any *bona fide* stockholder thereof. Application for such inspection must be made in writing to the Secretary, setting forth the reasons why inspection should be permitted. Attached to the application is required a certificate signed by the president or other principal accounting officer of such corporation, countersigned by the secretary, under the corporate seal of the company, that the applicant is a *bona fide* stockholder in the company. Where such certificate cannot be secured, other evidence will be considered to determine the fact whether or not the applicant is a *bona fide* stockholder. Upon receipt of such application the corporation whose return it is desired to inspect is notified of the facts and given opportunity to state whether any legitimate reason exists for refusing permission. The privilege of inspecting the return of any corporation is personal to the stockholders, and the permission granted by the Secretary to make such inspection cannot be delegated to any other person.[70]

[67] T. D. 2016. Reg. 45, Art. 1091.
[68] T. D. 2016. Reg. 45, Art. 1091.
[69] Reg. 45, Art. 1091; Reg. 33 Rev., Art. 26.
[70] T. D. 2016. Reg. 45, Art. 1091.

A person who, as trustee or in any other fiduciary relation, has the ownership of or possessory right to, stock in a corporation, is considered as a stockholder in such corporation.[71] By express exception in the Revenue Act of 1918[72] a *bona fide* stockholder of record, owning one per cent of the outstanding stock of a corporation, is entitled as of right to examine the returns of income of such corporation and its subsidiaries. A stockholder desiring the privilege of inspection must apply in writing to the Commissioner, specifying his address, the name of the corporation, its outstanding capital stock, the number of shares owned by him, the date of their acquisition, and whether or not he has the beneficial as well as the record title to such shares, and in other respects complying with the requirements of the regulations issued under the law.[73] A stockholder who has acquired his shares for the purpose of inspection of the income returns of the corporation is not a *bona fide* stockholder.[74] A stockholder who examines the return of a corporation and reveals without express authority of law any particulars of its statement of income is guilty of a misdemeanor and liable to fine and imprisonment.[75] Copies of returns on file in the Commissioner's office are not permitted to be sent to any person, except the corporation itself, or its duly authorized attorney, and in no case may the original returns be removed except under order and by direction of the Secretary or the President. A duly authorized attorney for this purpose is one possessing a properly executed power of attorney in writing from the corporation, which designation must be signed by two officers of the corporation and bear the impress of its seal.[76]

Corporations Which Offer Their Stock to the Public for Sale. The returns of all corporations whose stock is advertised in the press or offered for sale to the public by the corporation itself may be inspected by any person upon written application to the Secretary. The application must set forth briefly and succinctly all facts necessary to enable the Secretary to act upon the request. In case of doubt as to whether any company falls

71 Op. Atty. Gen. Dec. 27, 1910.
72 Revenue Act of 1918, § 257.
73 Reg. 45, Art. 1093.
74 Reg. 45, Art. 1093.
75 Revenue Act of 1918, § 257; Reg. 45, Art. 1094.
76 Reg. 33 Rev., Art. 226.

within this classification, the person desiring to see such return should support his application by advertisements, prospectus or such other evidence as he may deem proper to establish the fact that the stock of the corporation is offered for general public sale.[77]

CORPORATIONS WHOSE STOCK IS LISTED ON A STOCK EXCHANGE. The returns of all companies whose stock is listed upon any duly organized and recognized stock exchange within the United States, for the purpose of having its shares dealt in by the public generally, are open to the inspection of any person upon written application to the Secretary. Such application must set forth briefly and succinctly all facts necessary to enable the Secretary to act upon the request.[78]

Inspection of Returns by State Officers. By express exception in the Revenue Act of 1918 [79] the proper officers of a State imposing an income tax are entitled as of right, upon the request of its governor, to have access to the returns of income of any corporation, or to an abstract thereof, showing its name and income. Upon written application by the governor of a State as prescribed by the regulations, except that the application may be made directly to the Commissioner instead of to the Secretary, the Commissioner will set a convenient time for inspection of the returns (or an abstract thereof as he may determine) of corporations organized or doing business in such State. The authority to inspect returns granted to officers of a State includes authority to inspect lists furnished to supplement and become a part of the returns.[80]

Inspection of Returns by Government Officers. Returns of corporations (but not of individuals) may be inspected by an officer or employee of any department of the Government, on application to the Secretary by the head of the executive department in which such officer or employee is employed. If the return of a corporation is desired to be used in any legal proceedings other than

77 Reg. 45, Art. 1091.

78 Reg. 45, Art. 1091.

79 Revenue Act of 1918, § 257. It is to be noted that the law permits inspection only by officers of states which impose an income tax. This may not necessarily mean a tax on both corporations and individuals, but the privilege of inspecting returns applies only to the returns of corporations.

80 Reg. 45, Art. 1092.

those to which the United States is a party, or to be used in a manner by which any information contained in the return could be made public, the application for permission to inspect the return, or to furnish a certified copy, must be referred to the Attorney General for his recommendation before transmission to the Secretary.[81]

FOR USE IN GOVERNMENT SUITS. All returns, whether of individuals or of corporations, may be furnished, upon approval of the Secretary, for use in any legal proceedings before any United States grand jury, or in the trial of any cause to which both the United States and the person or corporation rendering the return are parties, provided the return would constitute material evidence in the prosecution, defense or trial of such action or proceeding. In any case relating to the collection of the income tax the Commissioner may furnish for the use of the proper officer either the original or certified copies of returns, without the approval of the Secretary.[82]

Statistics of Income. The Commissioner will publish annually a volume of statistics of income, showing, among other things, the distribution of income between corporations and individuals and by States, by classes and by occupations.[83]

[81] Reg. 45, Art. 1091.
[82] Reg. 45, Art. 1091; Reg. 33 Rev., Art. 227.
[83] Reg. 45, Art. 1101.

CHAPTER 35

ASSESSMENT AND PAYMENT OF THE TAX

The Revenue Act of 1918 introduces a number of substantial changes from the former method of assessing the tax and the method formerly provided for paying the same. The 1916 Law expressly provided that all assessments should be made by the Commissioner.[1] The Revenue Act of 1918 seems to contemplate the same rule. As soon as practicable after returns are filed, they are sent to the Treasury Department at Washington for assessment of the tax.[2] When an assessment under the 1916 Law was made the amount thereof was reported to the local collector, who notified the taxpayer on or before June 1 of such amount.[3] Under the 1918 law, the examination of a return by the Commissioner will lead to one of three results: (1) the return will be found to be correct; (2) the correct amount of tax will be *greater* than that shown in the return, or (3) the correct amount of tax will be *less* than that shown in the return. In the first case the tax is assessed on the basis of the taxpayer's return. In the second and third cases the four installments in which the tax is to be paid will be re-computed by the Commissioner. Under the 1916 Law, the tax became due on the 15th of June, but an additional period of grace, being at least ten days after June 15, was allowed before the application of penalties or interest.[4] As indicated above, the tax is now payable in four equal installments, the first at the time fixed by law for filing returns, the second, third and fourth installments on the 15th days of the third, sixth and ninth months respectively after such date. Provision is made in all cases for payment in one installment but no discount is allowed for such payment as was the case under the 1916 Law. If any installment is not paid when due, the whole amount of the tax unpaid becomes

1 Revenue Act of 1916, §§ 9 (a) and 14 (a).
2 Revenue Act of 1918, § 250.
3 Revenue Act of 1916, §§ 9 (a) and 14 (a).
4 See Revenue Act of 1916, §§ 9 (a) and 14 (a).

due and payable upon notice and demand by the collector; the difference between any installment as paid by the taxpayer and as re-computed by the Commissioner likewise becomes due and payable upon notice and demand by the collector. In the case of the first installment the instructions printed on the return are deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return is deemed sufficient notice of the amount due. Except in the cases of estates of insane, deceased or insolvent persons, if any tax remains unpaid after a tax is due and for ten days after notice and demand by the collector, the sum of 5% on the amount due but unpaid plus interest at the rate of 1% per month upon such amount from the time it became due is added as part of the tax, unless a *bona fide* claim for abatement has been filed.[5] The net result is that the tax is now payable in the case of taxpayers reporting on the basis of the calendar year in four installments on or before March 15, June 15, September 15 and December 15. In the case of taxpayers reporting on the basis of a fiscal year other than the calendar year, the same rules prevail, and the tax of such taxpayers will be payable on the 15th days of the third, sixth, ninth and twelfth months following the close of such fiscal year.[6] The Government may proceed by levying on and distraining the property of the taxpayer if payment of penalty and interest is not made within ten days from the date of the notice and demand for the tax.[7] This drastic means of enforcing payment is within the legislative power of Congress since the power to tax includes the power to undertake effectual means to collect the tax. A new remedy in the case of taxpayers designing quickly to depart from the United States or to remove their property from the United States or to conceal themselves or their property therein or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax is provided by the Revenue Act of 1918, and in such cases the Commissioner may declare the taxable period for such taxpayers terminated at the end of the calendar month then last past and otherwise proceed as indicated in a later paragraph.[8]

[5] Revenue Act of 1918, § 250 (e).
[6] Revenue Act of 1918, § 250.
[7] See p. 548.
[8] Revenue Act of 1918, § 250 (g).

Suit to Restrain Assessment or Collection. No suit for the purpose of restraining the assessment or collection of any tax may be maintained in any court.[9] The constitutionality of a law cannot be inquired into in an injunction suit against the government,[10] but may be in a stockholder's suit to enjoin a corporation from *voluntarily* paying a tax alleged to be unconstitutional.[11] An injunction will not be granted at the instance of a stockholder to restrain the officers of a corporation from paying the tax, other than voluntarily, as that would, in effect, be the same as an action to restrain the Government.[12] Allegations that an assessment is irregular and void do not constitute any ground for an injunction.[13] A bill in equity will not lie to enjoin collection although the tax is alleged in the bill to have been illegally assessed.[14] A collector cannot be restrained from collecting an assessment by injunction.[15] It is contrary to every principle of equity jurisprudence that the collection of taxes on personal property should be stayed by injunction.[16] The courts will not interfere by a mandamus with the executive officers of the Government in the exercise of their ordinary official duties.[17]. In matters which require an executive officer to exercise judgment or discretion no rule will issue for mandamus.[18] The inhibition of the Revised Statutes [19] applies to all asssessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing the income tax. The rem-

9 R. S. § 3224.

10 Delaware R. R. Co. v. Prettyman, 17 Int. Rev. Rec. 99; Allen v. Pullman's Palace Car Co., 139 U. S. 658; Dodge v. Brady, 240 U. S. 122.

11 Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; Flint v. Stone-Tracy Co., 220 U. S. 107; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Stanton v. Baltic Mining Co., 240 U. S. 103.

12 Strauss v. Abrast Realty Co., 200 Fed. 327.

13 Alkan v. Bean, 23 Int. Rev. Rec. 351.

14 Snyder v. Marks, 109 U. S. 189; Dodge v. Osborn, 240 U. S. 118.

15 State R. R. Tax cases, 92 U. S. 575; Keely v. Sanders, 99 U. S. 441.

16 Nye v. Washburn, 125 Fed. 818.

17 U. S. v. Black, 128 U. S. 40. The court in this case followed an earlier decision of Decatur v. Paulding (14 Pet. 497) and made clear the distinction between the mere ministerial act of the executive officer, which may be controlled by the courts by mandamus, and an act in the performance of which an officer is vested with quasi-judicial discretion.

18 Carrick v. Lamar, 116 U. S. 423.

19 R. S. § 3224.

edy of a suit to recover back the tax after it is paid is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it. The system of administrative measures, not judicial, to collect internal revenue taxes, with appeals to specified tribunals, and suits to recover back moneys illegally exacted is a system of corrective justice intended to be complete, and enacted under the right belonging to the Government to prescribe the conditions on which it will subject itself to the judgment of the courts in the collection of its revenues.[20] In a recent case the question arose whether or not a suit against a collector to cancel a sale to the government of the taxpayer's real estate to satisfy a tax assessed against him was prohibited and whether or not the word "restrain," as above used, should be construed in a narrow sense as prohibiting the issuance of restraining orders and injunctions or in a broad or liberal sense as applying to all suits to hinder or impede the collection of taxes. The court adopted the broader and more liberal definition.[21] The prohibition of such suits cannot be waived by any officer of the government.[22] Despite this general rule receivers, as officers of the court, may, where they deem the property or income from the property in their charge not subject to the tax as contended by collecting officials, apply to the appointing court for instructions as to payment.[23]

Time of Payment of Tax. Except as to any taxes paid at the source, the income tax is ordinarily paid in four equal installments.[24] The first installment is paid at the time fixed by law for filing the return, the second, third and fourth installments on the fifteenth days of the third, sixth and ninth months respect-

20 Dodge v. Osborn, 240 U. S. 118.

21 Gouge v. Hart, 250 Fed. 802. This case is now No. 506 on the docket of the United States Supreme Court. See Reg. 45, Art. 1037.

22 Reg. 45, Art. 1037.

23 Scott v. Western Pac. R. Co., 246 Fed. 545.

24 Under the 1916 Law, the Secretary, under rules and regulations prescribed by him, was required to permit taxpayers to make payments in advance in installments of an amount not in excess of the estimated taxes which would be due from them, and upon determination of the taxes actually due any amount paid in excess was refunded as taxes erroneously collected. The Secretary might allow a credit against taxes so paid in advance of an amount not exceeding the rate of 3% per annum. (Act of October 3, 1917 (Public No. 50), § 1009; T. D. 2622.)

ively following such date. There are now four due dates: to wit., March 15, June 15, September 15, and December 15 in the case of taxpayers reporting on the basis of a calendar year, and the 15th days of the third, sixth, ninth and twelfth months following the close of the fiscal year of taxpayers reporting on the basis of a fiscal year other than the calendar year.[25] The payment of the tax may be made at any time on such due dates. If payment is made by mail the remittance should be mailed in due time to reach the collector on the due date. To accommodate those who make payments after closing time a mail box is provided at the cashier's window in the office of the local collector for the deposit of such collections.[26]

Extension of Time for Payment. An unconditional extension of time for filing a return will postpone the date for payment of the first installment, but will not postpone the date of payment of the other installments unless so specified in each case.[27] In case an extension is granted on request of the taxpayer, interest at the rate of ½ of 1 per centum per month is added to the installment from the date it would have been due if no extension had been granted, that is, the original due date, until the installment is paid.[28]

Advance Payment of Tax. Income taxes may at the option of a taxpayer be paid in advance and in a single payment instead of installments, in which case the total amount must be paid on or before the time fixed by law for filing the return, or such time as extended, to wit, March 15th or the fifteenth day of the third month following the close of a fiscal year other than the calendar year as the case may be.[29]

Assessment of Tax. When the returns are received at the collectors' offices, they are examined and listed before being forwarded to the Commissioner. If it appears that the tax is greater or less than shown in the return, it is re-computed. After checking the figures the Commissioner assesses the tax on the basis of the collectors' lists. The collectors then send out bills for the taxes,

25 Revenue Act of 1918, § 250 (a). This section omits the ten-day period of grace allowed under the former law. (T. D. 2840.)

26 T. D. 1728; Reg. 45, Art. 1007.

27 Reg. 45, Art. 1001.

28 Revenue Act of 1918. § 250 (a).

29 Revenue Act of 1918, § 250 (a); Reg. 45, Art. 1001.

either as computed by the taxpayer or as re-computed. If a taxpayer believes that he has been overassessed, he may file a claim for abatement or (after payment of the tax) for a refund of the excess. As soon as practicable the returns are carefully audited by accountants in the office of the Commissioner at Washington, assisted where necessary by reports of the examination of taxpayers' books and records made by revenue agents in the field. If error in a return is detected, the taxpayer is notified accordingly and an additional assessment is made against him or he is given the opportunity to file a claim for a refund, as the case may be. Any assessment must be made within five years after the return was due or was made, except in the case of false returns with intent to evade the tax.[30]

Notice and Demand for Tax. The law provides[31] for five notices and demands upon the taxpayer by the collector. The first is a notice and demand for the whole amount of the tax unpaid, upon default in the payment of any installment. The second is a notice and demand for the difference between the amount of tax computed in the taxpayer's return and the amount re-computed by the Commissioner. The third is a notice and demand by the collector under a return made pursuant to the Revised Statutes.[32] The fourth is a notice and demand for any tax remaining unpaid after the date when it is due. The fifth is the notice and demand imputed to the taxpayer in respect of the first installment.[33] Under these provisions the Treasury Department sends out notice and demand (called "Statement of Tax Due") for the tax (Form 1123) sufficiently in advance of June 15, September 15, and December 15, (or the corresponding dates in the case of taxpayers making returns on the basis of fiscal years) to give the taxpayer ten days' notice and demand before each of such dates. In this manner, on the 15th days of June, September, and December, the tax is due and the taxpayer has had a notice and demand by the collector ten days previously. If the required installment is not paid by such dates, the penalties and interest

30 Reg. 45, Art. 1012.

31 Revenue Act of 1918, § 250; Reg. 45, Arts. 1001-1012.

32 R. S., § 3176.

33 The first three notices and demands are covered respectively by subdivisions (a), (b) and (c); the fourth and fifth by subdivision (e) of § 250.

provided by the law will attach.[34] In addition, the whole amount of tax unpaid will become due and payable upon a further notice and demand by the collector in accordance with the first of the above stated notices and demands. The second and third of the above stated notices and demands both refer to an amount of tax not computed by the taxpayer, but one computed by the Internal Revenue Department. The second notice and demand is for a tax re-computed by the Commissioner after his examination of the return. The third notice and demand is for a tax assessed after a return made by a collector or the Commissioner in accordance with Section 3176 of the Revised Statutes. Both these notices and demands are for additional taxes or for taxes computed by the Treasury Department in the absence of any computation by the taxpayer. In such cases, the ten-day period of grace applies, or at least no penalties attach until the additional tax has been demanded.[35] With regard to the first installment of the tax, the statute provides that the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due, and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.[36]

SERVICE OF NOTICE AND DEMAND. Notice and demand may lawfully be given by mail and when so given is presumed to have been received. The burden rests on the taxpayer to prove the contrary in order to avoid the penalty.[37] The time within which

34 T. D. 2840.

35 See "Notice and Demand for Tax" (Form 1-17) and "Second Notice and Demand for Tax" (Form 1-21).

36 Reading this provision in connection with the first sentence of subdivision (e) of § 250, it may be argued that on March 15th the taxpayer has had sufficient notice of the date when the tax is due (March 15th) and of the amount of tax due, and also sufficient demand; that by virtue of the first sentence of subdivision (e) the taxpayer has ten days after such demand within which to pay the tax without penalty. On the other hand, it may be argued that the words "sufficient demand" are intended as to the first installment to be paramount in effect, to the first sentence of subdivision (e); that is, that the instructions printed on the return constitute sufficient demand in the case of the first installment and that the taxpayer has not ten days after demand within which to pay the tax. The former of these interpretations would make the first due date March 25th, and the latter March 15th. The former seems to be a more reasonable interpretation of the language, and the latter to be more consistent with the statute in general.

37 U. S. v. General Inspection and Loading Co., 204 Fed. 657; Reg. 45, Art. 1007.

the tax must be paid runs from the date of mailing the notice and not of its receipt by the taxpayer.[38] The practice of the Department in such cases has been to permit the taxpayer to show, to the satisfaction of the Commissioner, that he did not receive the notice, and upon such showing to give the taxpayer an opportunity to pay his taxes without penalty. The record of the collector showing that notice had been duly mailed is considered merely as *prima facie* evidence that the notice was received.[39] The date appearing on the notice and demand, as the last date on which the tax may be paid without penalty, should be a date ten days subsequent to the actual mailing of the notice and not necessarily ten days from the date of the notice. The date of mailing controls.[40]

NOTICE AND DEMAND TO ABSENTEES. By reason of absence from their homes or places of business in foreign countries or in the military or other service of the country and the consequent delay in receiving mail, or by reason of the location of the residence of an individual or of the office of a corporation to which the notice was addressed at a distance from the collector's office, it is impossible for many persons to receive a notice and demand and to make payment of the tax so that such payment may be received by the collector within the ten-day period following the service of notice and demand, and in all such cases the collector will enter on the notice as the date on which the tax becomes due and payable a date as nearly as possible ten days after the time that the notice should be received in the ordinary course of the mails by the taxpayer. In such cases when it appears that a remittance for the tax was placed in the mails within the ten-day period after the date specified in the notice, and in cases where tardiness is occasioned because the notice was not delivered in due time by reason of delay in the mail and satisfactory evidence of that fact is furnished, the penalty and interest will not be collected.[41]

Medium of Payment of Tax. As a general rule, payment of the tax is authorized by law[42] to be made in certified checks drawn in favor of the collector on national and state banks and trust

[38] Reg. 45, Art. 1007.
[39] I. T. S. 1917, ¶ 2268; Reg. 45, Art. 1007.
[40] T. D. 1659.
[41] Reg. 45, Art. 1007.
[42] Act of March 2, 1911 (36 Stat. 965).

companies located in the city where the collector has his office, and also such "out-of-town" certified checks as can be cashed without cost to the government, providing the depositary will accept for deposit "out-of-town" certified checks "without recourse." Prior to 1917 the Treasury Department did not specifically authorize the acceptance of any form of exchange in payment of internal revenue taxes, other than currency and such certified checks as are above described.[43] There was no objection to a collector accepting at his own risk, or at the risk of the government depositary, uncertified checks or any other form of exchange, for collection only.[44] Where a form of remittance not authorized by law was accepted for collection, the 5% penalty was incurred by the taxpayer, if there was delay in collection and the funds were not actually received by the collector within the time provided by law. Receipt by the Government depositary, in the course of collection, was held not to be receipt by the collector, as the depositary is not an agent of the collector or of the government.[45] At present the law provides that collectors may receive at par with an adjustment for accrued interest, certificates of indebtedness issued by the United States in payment of income, war-profits and excess-profits taxes and any other taxes payable otherwise than by stamps.[46] Under the same provision of law collectors may also receive uncertified checks in payment of such taxes during such time, and under such regulations, as the Commissioner, with the approval of the Secretary shall prescribe; but if a check so received is not paid by the bank on which it is drawn, the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.[47] The date on which the collector receives an uncertified check in payment of the tax is considered the date of payment, unless the check is returned dishonored.[48] If payment is made by check the taxpayer as a precaution should draw the check for such amount as to cover any

[43] T. D. 1990.

[44] T. D. 2158.

[45] T. D. 1651.

[46] Revenue Act of 1918, § 1314; Reg. 45, Arts. 1731-1732.

[47] Revenue Act of 1918, § 1314; T. D. 2851; see Act of October 3, 1917 (Public No. 50), § 1010.

[48] Reg. 45, Art. 1733; T. D. 2627; T. D. 2851.

collection charges by the bank, in order that the net amount received by the government may be the full amount of tax due, that is, checks must be collectible at par, and taxpayers who are not sure that their checks will be paid at par, should write beneath the amount the words "without deduction for exchange" or the words "with exchange." A collector is not required to examine all checks to see whether or not they are collectible at par, but will stamp on the face of each the words "this check is in payment of an obligation to the United States and must be paid at par. No protest," with his name and title. If the bank on which the check is drawn should refuse to pay it at par, it will be returned through the depositary bank and will be treated in the same manner as a bad check. If any check is returned unpaid, it will be held in suspense a few days, during which time the collector will make an effort to recover the amount from the taxpayer. If the amount is recovered, the bad check will be returned to the drawer; if it is not recovered, the collector will proceed to collect the taxes by the usual methods, as though no check had been given. All expenses incident to the attempt to collect such a check and the return of it through the depositary bank must be paid by the drawer of the check to the bank on which it is drawn, since no deduction can be made from amounts received in payment of taxes. A taxpayer who tenders a certified check in payment for taxes is also not released from his obligation until the check has been paid.[49] If one check is remitted to cover two or more persons' taxes, the remittance must be accompanied by a letter of transmittal stating (a) the name of the drawer of the check; (b) the amount of the check; (c) the amount of any cash, money order or other instrument included in the same remittance; (d) the name of each person whose tax is to be paid by the remittance; (e) the amount of the payment on account of each person; and (f) the kind of tax paid.[50] In the payment of the tax and in each step or computation necessary in determining the amount of such tax, the fractional part of a cent is disregarded unless it amounts to a half cent or more, in which case the fraction is increased to one cent.[51]

[49] Reg. 45, Art. 1734; T. D. 2666; T. D. 2851.
[50] Reg. 45, Art. 1733; T. D. 2851.
[51] Revenue Act of 1918, § 1313; Reg. 45, Art. 1721; Reg. 33 Rev., Art. 41.

PAYMENT OF TAX BY CERTIFICATES OF INDEBTEDNESS. The terms of the acceptance of certificates of indebtedness are prescribed from time to time. The amount at par of the certificates of indebtedness presented by any taxpayer in payment of taxes must not exceed the amount of the taxes to be paid by him. Collectors are not authorized, unless otherwise notified by the Secretary to receive as payment of income or profits taxes interim receipts issued by Federal Reserve banks in lieu of the definite certificates of the series. For the purpose of saving taxpayers the expense of transmitting such certificates as are held in Federal Reserve cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay income and profits taxes by Treasury certificates of indebtedness acceptable in payment of such taxes, should communicate with the collector of the district in which the taxes are payable and request from him authority to deposit such certificates with the Federal Reserve Bank in the city in which the certificates are held. Collectors are authorized to permit deposits of Treasury certificates of indebtedness in any Federal Reserve Bank with the distinct understanding that the Federal Reserve Bank is to issue a certificate of deposit in the collector's name covering the amount of the certificates of indebtedness at par and to state on the face of the certificate of deposit that the amount represented thereby is in payment of income and profits taxes. The Federal Reserve Bank should forward the original certificate of deposit to the Treasurer, with its daily transcript, and transmit to the collector the duplicate and triplicate, accompanied by a statement giving the name of the taxpayer for whom the payment is made in order that the collector may make the necessary record and forward the duplicate to the office of the Commissioner.[52]

PROCEDURE WITH RESPECT TO CERTIFICATES OF INDEBTEDNESS. Such certificates of indebtedness may be accepted by the collector prior to the date the tax is due and in that case should be forwarded by the collector to the Federal Reserve Bank to be held for his account until the date the tax is due and for deposit on such date. All coupons maturing on or before the date the tax is due must be detached by the taxpayer and collected in ordi-

[52] Reg. 45, Art. 1731 as amended and supplemented by T. D. 2907 and T. D. 2918. See T. D. 2639.

nary course, but all other coupons must remain attached to the certificate and be forwarded to the Federal Reserve Bank. Any accrued interest to the date the tax is due, not covered by coupons detached as above provided, will be remitted to the taxpayer by the Federal Reserve Bank by check, for which purpose the collector will furnish to the bank the name and address of the taxpayer, the amount and serial numbers of the certificates presented in each case, the date of issue of the certificates, and the date the tax is due. Collectors may in no case pay interest on such certificates nor accept them for an amount other or greater than their face value. Receipts given by collectors to taxpayers should show the amount of certificates of each series received in payment of taxes. For the purpose of saving taxpayers the expense of transmitting such certificates as are held in federal reserve cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay taxes by acceptable certificates of indebtedness should communicate with the collector and request from him authority to deposit such certificates to his credit with the Federal Reserve Bank in the city in which the certificates are held.[53]

Excess Payment of Tax. If upon examination of any return made pursuant to the 1909 Law, the 1913 Law, the 1916 Law, as amended, the 1917 Law, and the Revenue Act of 1918 it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, the amount of such excess will be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return and any balance of such excess will be immediately refunded to the taxpayer. No such credit or refund will be allowed or made, however, after five years from the date when the return was due, unless before the expiration of such five years, a claim therefore is filed by the taxpayer.[54]

CLAIMS FOR CREDIT OF TAXES ERRONEOUSLY COLLECTED. To obtain the credit mentioned in the preceding paragraph the taxpayer should proceed as follows: (1) Where the credit demand-

[53] Reg. 45, Art. 1732.

[54] Revenue Act of 1918, § 252. The rule stated in the text prevails notwithstanding R. S., § 3228. Prior to the enactment of this provision an excess payment of tax in one year could not be offset against an assessment of tax for a subsequent year. (Reg. 33 Rev., Art. 39.)

ed is equal to or less than any outstanding assessment of tax, a taxpayer desiring to obtain such credit shall file with the collector for the district in which his original return was filed a claim on Form 47 A, which shall be sworn to and shall contain the following statements: (a) business engaged in by claimant; (b) character of assessment; (c) amount of tax paid and for what taxable year; (d) portion of tax under (c) claimed as a credit; (e) unpaid assessment against which credit is asked and for what taxable year; and (f) all facts regarding the overpayment. (2) Where the amount claimed as a credit is greater than the outstanding assessment of tax, a taxpayer desiring to obtain such credit and the refund to which he is entitled shall file, in addition to the claim for credit required to be made on Form 47 A for the amount of the outstanding assessment, a claim for refund of the overpayment in excess of the credit. This claim for refund may be attached to the claim for credit or it may be separately filed with the Commissioner. All the facts regarding the total overpayment should be stated in the claim for refund and a reference made to such claim in the claim for credit.[55]

ACTION ON CLAIMS FOR CREDIT. Upon receipt of a claim for credit on Form 47 A the collector must certify thereon the required information concerning all outstanding assessments and payments covered thereby and note on his records that a claim for credit has been filed. He thereupon transmits the claim to the Commissioner. Due notice will be given the collector and the taxpayer of the action taken on the claim. A schedule of credit claims on Form 7220 A will be transmitted to the collector once a month and formal credit shall be taken by the collector at that time. If a claim is allowed against additional taxes due for other years, but such other taxes have not yet been assessed, only the amount of the excess of such taxes over the overpayment shall be assessed, or the excess of the overpayment over such other taxes due shall be refunded, as the case may be. A taxpayer desiring to convert a claim for refund previously filed into a claim for credit may file with the collector a claim on Form 47 A, referring in it to such claim for refund. Upon its receipt by the Commissioner the claim for credit will be attached to the claim for refund and will be adjusted in the same

[55] Reg. 45, Art. 1034.

manner as if the taxpayer had originally filed the claim for credit. The effective date of filing of the claim for credit shall be the actual date of filing such claim with the collector. The filing of a claim for credit against a tax due under another return is subject to the same rules with respect to the addition of interest and penalties as if the taxpayer had filed a claim for abatement of the tax against which credit is desired.[56]

Recovery of Taxes Paid. Taxes erroneously paid or illegally exacted may on occasion be recovered in either of two ways: (1) from the Commissioner, and (2) by an action at law against the government or the collector who received payment thereof. Generally speaking and subject to the exceptions and definitions noted in the following paragraphs, two elements are essential to the taxpayer's right of recovery: (1) he must have protested against the assessment[57] or collection of the tax sought to be recovered, and (2) such tax must have been paid under some form and degree of duress or coercion.

RECOVERY OF TAXES FROM COMMISSIONER. The universally recognized principle that an action cannot be maintained for the recovery of money paid in discharge of a tax illegally assessed, unless payment was made under protest has been held by the Commissioner and other officers of the Department to be too technical and too exacting for application to the refund of taxes under Section 3220 of the Revised Statutes,[58] and it would seem that a protest is not necessary to recover taxes from the Commissioner. But such a protest is essential if suit is to be maintained against an *adverse* decision of the Commissioner.[59]

RECOVERY BY ACTION AT LAW. The two above mentioned essentials or conditions to the right to recover taxes erroneously paid or illegally exacted are ordinarily requisite when recovery is sought by means of an action at law, as contradistinguished from an application to the Commissioner for a refund. There is some irreconcilable conflict between various dicta, if not deci-

56 Reg. 45, Art. 1035.

57 It has been held that a protest against the assessment is sufficient since any protest against the collection would be unavailing. The law does not require a person to do what can be of no effect. (Adams v. U. S., 1 Ct. Cl. 306.)

58 Real Est. Savings Bank v. U. S., 16 Ct. Cls. 335, Int. Rev. Rec. 154, affirmed 104 U. S. 728; Chesebrough v. U. S., 192 U. S. 253.

59 Chesebrough v. U. S., 192 U. S. 253.

sions, of the Supreme Court and the lower federal courts in considering the nature of and necessity for a protest and duress in regard to the recovery of internal revenue taxes, and while the scope of this book does not permit an exhaustive examination of the authorities, the subject is considered in the following paragraphs in the light of some of the leading cases.

Payment Under Protest. The ancient principle of the common law is of general application that taxes voluntarily paid cannot be recovered back even if they have been illegally laid or the law under which they were laid proves to be unconstitutional. The rule is founded upon the knowledge of law imputed to all taxpayers; it is also said to be one of sound public policy and quiet and good faith, operating to free the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence.[60] When a voluntary payment of taxes is spoken of, the word "voluntary" is not used in its ordinary and popular sense.[61] The purpose of paying a tax under protest is, briefly, to preserve the taxpayer's rights to recover the tax should the assessment thereof prove to be wrongful or excessive, or the law under which it was laid void and unconstitutional. Since it is usually held that the making of a protest and the existence of duress are concomitant conditions to any recovery of taxes which have been paid, the necessity for a protest will be more fully discussed in a later paragraph. It appears that a collector is not personally liable for taxes if no protest or objection is made to their collection by him.[62]

Protest at Time of Filing Return. It does not seem essential, although it may be a wise precaution, also to protest at the time of filing the return upon which the assessment is based.

Form of Protest. There is no statutory requirement that a protest against the assessment and collection of internal revenue taxes be in writing.[63] A written protest is, of course, better evi-

60 Cooley on Taxation (Third Edition) Vol. II, Ch. XXIV, p. 495.

61 In many of the cases cited hereafter in which the payment involved was held to be voluntary, the payment was most unwillingly and reluctantly made.

62 Commissioners, etc., v. Buckner, 48 Fed. 533.

63 Wright v. Blakeslee, 101 U. S. 174; Stewart v. Barnes, 153 U. S. 456; Swift v. U. S., 111 U. S. 22; Shaefer v. Ketchum, 21 Fed. Cas. No. 12,693. In this respect the rule in regard to internal revenue taxes differs from that in regard to customs in which case a protest must be in writing.

dence. A protest against paying the tax includes the penalties without specific mention of the latter.[64] In one case in which a corporation had been assessed for taxes and the same were not paid, a writ of distraint was issued by the collector, and, the corporation having been notified that the tax would be collected by levy, the deputy collector counted out and took from a representative of the company a sufficient amount to pay the tax against verbal protest at the time. A written notice of protest was then served in which the corporation denied that it was liable to the tax. The court held that the protest was sufficient.[65] Under the 1909 Law the Treasury Department ruled that no form of protest was prescribed, that any form of protest would be sufficient if filed before payment of the tax, and that the right of protest was not to be denied.[66]

PROTEST ALONE NOT SUFFICIENT. A protest is used to give effect to attending circumstances; it gives notice that the payment is not to be considered as admitting the right of the taxing power to make demand for or to collect the tax in question. But as appears in the next paragraph, there must usually be duress or coercion, and if payment is made under protest alone without some form or degree of compulsion, the payment may be considered voluntary notwithstanding a protest was made.[67] It has been stated:[68] "Though there is some conflict in the dicta of the Supreme Court, the true doctrine seems to be that when taxes are paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such a suit to recover has been established." This statement is difficult to reconcile with the authorities cited in the next paragraph.

64 Wright v. Blakeslee, 101 U. S. 174.

65 Abrast Realty Co. v. Maxwell, 206 Fed. 333.

66 T. D. 1675.

67 Lamborn v. Comm'rs, 97 U. S. 181; Merck v. Treat, 202 Fed. 133.

68 Herold v. Kahn, 159 Fed. 608. This remark of the court seems to be mere dictum since in the first place, the tax involved was paid under a mistake of fact and in the second place, there was probably duress in the notice sent by the collector stating that unless the tax was paid, "it will be my duty to collect the same with a penalty * * *" (See next paragraph). The case of Beers v. Moffat, 192 Fed. 984, contains the same doctrine, but recovery was denied because there was no protest or demurrer to the legality of the tax or its payment.

Duress. The general rule is that where a party pays an illegal demand, with full knowledge of all the facts rendering it illegal, without an immediate and urgent necessity therefor, to release his person or property from detention, or to prevent an immediate seizure of his person or property, such payment must be deemed voluntary, and cannot be recovered back.[69] It will be noted that a voluntary payment is among other things a payment "with full knowledge of all the facts rendering it illegal." A payment made without such knowledge may under certain circumstances be recovered, but not on the theory of duress. The yielding to paramount taxing authority involved in the payment of a tax under duress or coercion is quite different from a payment made under a mistake of fact; that is, a payment made when such full knowledge is wanting. This distinction is illustrated by a case [70] in which at the time certain executors paid an internal revenue inheritance tax on a life estate under protest, they had no knowledge that the life tenant had died and that the life estate had, therefore, terminated so that it was improper to use life tables to determine the value of such life estate. When knowledge is thus spoken of, however, the reference is to knowledge of facts, and not knowledge of law, which all taxpayers are presumed to have.[71] If a payment is made under a mistake of law, no relief exists. Thus in one case an importer who formally entered goods imported from Porto Rico and purchased the required stamps without protest or objection or duress in the belief that the tax was lawfully due, although the goods were not in fact lawfully taxable, was held to have made his own interpretation of law and his payment of tax was held voluntary.[72] Thus a tax paid under a statute later declared unconstitutional cannot be recovered on the theory of mistake if voluntarily paid, since the mistake is one of law.[73] It has been stated that taxes ille-

69 Little v. Bowers, 134 U. S. 547; Railroad Co. v. Comm'rs, 98 U. S. 541; Lamborn v. Comm'rs, 97 U. S. 181.

70 Kahn v. Herold, 147 Fed. 575, affirmed 159 Fed. 608.

71 Lamborn v. Comm'rs, 97 U. S. 181.

72 Newhall v. Jordan, 149 Fed. 586. See, however, Elliott v. Swartwout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 266.

73 Lamborn v. Comm'rs, 97 U. S. 181. In Chesebrough v. U. S., 192 U. S. 253, and U. S. v. N. Y. & Cuba Mail S. S. Co., 200 U. S. 488, the constitutionality of the acts imposing the tax was attacked, but the court (except the lower court in the Chesebrough case which was reversed) did not find it neces-

gally assessed and paid may always be recovered back if the collector understands from the payer that the taxes are regarded as illegal and that suit will be instituted to compel the refunding of them.[74] In the case containing this doctrine the tax recovered was one on thimble-skeins and pipe-boxes of iron which were exempt. The tax, therefore, was paid under a mistake of law and although the facts are only briefly reported, there seems to have been an absence of such duress or coercion as to make the payment an involuntary one. The same absence of duress or coercion appears in other early cases.[75] In a suit to recover back real property taxes paid by the Union Pacific Railroad Company to Dodge County, Nebraska, it appeared that in due time the tax lists with warrants attached for their collection were delivered to the treasurer of the County. These warrants authorized the treasurer, in order to enforce collection, to seize the personal property of any persons making default in the payment of any taxes charged

sary to consider such constitutionality since the payments were held to be voluntary and the mistake in making payments, if any, was one of law. (See also Union Pacific Co. v. Dodge, 98 U. S. 541.)

[74] Erskine v. Van Arsdale, 15 Wall. 75. This statement was contained in a charge of the lower court to the jury which was sustained by the Supreme Court. (See next note.)

[75] Elliott v. Swartout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 266; Philadelphia v. Collector, 5 Wall. 720; Collector v. Hubbard, 12 Wall. 13. In the first two of these cases, which were customs cases, the payments were made to release goods held for duties on imports and the protest became necessary in order to show that the legality of the demand was not admitted when payment was made. The recovery rested upon the fact that the payment was made to release property from detention and the protest saved rights which grew out of that fact. The detention of property under such circumstances would seem to constitute duress. (See, however, Newhall v. Jordan, 149 Fed. 586 in which it was conceded that the importer could not have obtained possession of the goods without making the payment, recovery being still denied. See also U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488.) In the third and fourth of these cases, which were internal revenue cases, recovery was based upon the ground that the several provisions in the acts under which the taxes were imposed warranted the conclusion as a necessary implication that Congress intended to give the taxpayer the remedy to recover, it being expressly so stated in the fourth case. The case of Erskine v. Van Arsdale, 15 Wall. 75, (see note 70) probably falls within the same class as the third and fourth cases. It is to be noted that the Court in Herold v. Kahn, 159 Fed. 608, uses Philadelphia v. Collector, 5 Wall. 720, as one of its authorities for the statement which has been criticised above. (See note 68.)

upon the lists. No demand for taxes was necessary, it being the duty of every person subject to taxation to attend at the treasurer's office and make payment. The company so attended and made payment filing at the same time a protest in general terms containing no specification of alleged illegality, or designation of particular property as wrongfully included in the assessment. Although the company had personal property in the county which might have been seized, no special effort had been made or active steps taken to enforce collection, and no other notice given by the taxing authorities than such as the law implied. Three years afterward a case was decided which was supposed to hold that the particular lands were exempt from taxation, whereupon the company brought suit to recover the taxes involved. It was held that no such immediate and urgent necessity for the payment of the taxes in controversy existed as to imply that such payment was made under compulsion.[76] In what is perhaps the leading case[77] on the subject of duress, stamps were purchased from the collector for the purpose of affixing them to a deed to a building company. The collector was not informed at the time of the purchase of this particular purpose and no intimation, written or oral, was given him of any claim by the purchaser of the stamps that the law requiring the affixing of the stamps was unconstitutional and that he was making the purchase under duress. About 19 months after the payment, an application was made to the Commissioner for a refund which was denied. It was held that no duress existed. While this case is cited as an authority for the general rule stated at the beginning of this paragraph and does not appear ever to have been questioned, its facts do not even disclose the making of a protest,[78] and the

[76] Union Pacific Co. v. Dodge, 98 U. S. 541. The provisions of the state statute levying the tax involved in this case do not clearly appear, but it may well be that the rule as to what constitutes duress in cases of real property taxation may vary from the rule in cases arising under the internal revenue laws. For instance, the owner of real property always has his action of ejectment. To the same general effect see Simons v. U. S., 19 Ct. Cls. 601, where the taxpayer paid the tax to obtain possession of his property; Christie Street Co. v. U. S., 126 Fed. 991 (internal revenue cases).

[77] Chesebrough v. U. S., 192 U. S. 253. The court cites Little v. Bowers, 134 U. S. 549; and Union Pacific Co. v. Dodge, 98 U. S. 541 in support of its conclusion.

[78] The court held that an application to the Commissioner under Section 3220 was not the statutory equivalent of a common law protest or notice of suit.

only duress claimed did not come from the government or its agents but from a third party.[79] Beyond this and in the light of its facts it is not, strictly speaking, an authority upon the question of duress and the court intimates that the rule as to duress is less rigorous on some occasions than on others.[80] In another case,[81] however, duress as to the stamp tax on manifests of cargoes was claimed in that clearance papers for vessels bound to foreign ports could not be obtained without stamped manifests without which in turn such vessels would be prevented from sailing and their masters liable to a penalty. The court held that such facts did not constitute duress. Further doubt has been thrown upon this entire question by a comparatively recent case,[82] in which the taxing statute in controversy contained self-executing or automatic provisions for its enforcement, whereby corporations failing to pay the tax forfeited their rights to do business within the state and incurred a penalty. The court said in part: "It is reasonable that a man who denies the legality of a tax should

79 It appeared that the vendee was unwilling to accept an unstamped conveyance and that stamps were affixed in order to complete the transaction and obtain the consideration. But the court said that "if that constituted duress as between Chesebrough and his building company it was a matter with which the collector had nothing to do."

80 Note the following language of the court: "At the same time, when taxes are paid under protest that they are being illegally exacted, or with notice that the payer contends that they are illegal, and intends to institute suit to compel their repayment, a recovery in such suit may, *on occasion*, be had, although generally speaking, even a protest or notice will not avail if the payment be made voluntarily. * * * As we have said, the purchase of these stamps was purely voluntary, and if, *notwithstanding, recovery could be had, it could only be on protest or notice,* and there was none such here, written or verbal, formal or informal."

81 U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488. In this case as in Chesebrough v. U. S., 192 U. S. 253, the collector was not informed at the time of the purchase of the particular purpose for which the stamps were to be used, and no intimation was given him, written or oral, that the taxpayer claimed that the law regarding such stamps was unconstitutional and that it was making the purchase under duress. The court said that all determining conditions were the same as in the Chesebrough case.

82 Atchison v. O'Connor, 223 U. S. 280. See also Gaar, Scott, & Co. v. Shannon, 223 U. S. 468, in which the court said in part: "Neither a statute imposing a tax, nor the execution thereunder, nor a mere demand for payment, is treated as duress. It does not necessarily follow that there will be *duress of goods*."

have a clear and certain remedy. The rule being established that, apart from special circumstances, he cannot interfere by injunction with the state's collection of its revenues, an action at law to recover back what he has paid is the alternative left. Of course, we are speaking of those cases where the state is not put to an action if the citizen refuses to pay. In these latter he can interpose his objections by way of defense; but when, as is common, the state has a more summary remedy, such as distress, and the party indicates by protest that he is yielding to what he cannot prevent, courts sometimes, perhaps, have been a little too slow to recognize the implied duress under which payment is made. But even if the state is driven to an action, if, at the same time, the citizen is put at a serious disadvantage in the assertion of his legal, in this case of his constitutional, rights, by defense in the suit, justice may require that he should be at liberty to avoid those disadvantages by paying promptly and bringing suit on his side. He is entitled to assert his supposed right on reasonably equal terms." A clearer definition than exists at present of the nature of, and necessity for a protest and duress in regard to the recovery of internal revenue taxes would be of material assistance both to the taxpayer and the government, since the present uncertainty, instead of freeing the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence, is calculated to fill the courts with questions which do not go to the merits of taxation controversies. The more liberal rule of implied duress suggested by the Supreme Court in the case,[83] referred to above, if properly extended and applied, would relieve many taxpayers objecting in good faith to the imposition of a tax from the risk

[83] Atchison v. O'Connor, 223 U. S. 280. Almost all taxing statutes now contain summary and other drastic remedies for failure to pay the tax at the appointed time. Under the presumption that officers of the law will fulfill their duties a considerable extension of the doctrine of duress implied from a statute imposing a tax might well be made without detriment to the government's interests. It is seldom that the government and the taxpayer are on equal terms or that the latter has any choice but to do what the Government officials require. Indeed, the only alternative of a taxpayer may sometimes be as in Swift v. U. S., 111 U. S. 22, to submit to an illegal exaction or discontinue business. It would seem that a clear protest should always be required.

of incurring a penalty in order to come technically within the present rule as to involuntary payments.[84]

PAYMENT AFTER RECEIPT OF FORM 1123. Form No. 1123, which is sent out ten days before the second, third and fourth due dates, makes "demand" for the tax, but does not contain any threats of penalties to be exacted in the event of non-payment. Under

[84] One of the most liberal cases upon the question of duress is the case of Underwood Typewriter Company v. Chamberlain, (Conn.), 102 Atl. 600. In this case the state contended that the taxpayer had made a voluntary payment of the tax in question. The statute under which the tax was paid provided that the tax would become due on or before August 1; that ten days thereafter and upon notice and demand of payment, 5% of the unpaid tax would automatically be added to it and interest at the rate of three fourths of one per cent per month upon such tax from the date the tax became due would also be added; that the unpaid tax became a lien upon the real estate of the company within the state from the time the tax became due and was unpaid and from the filing of certificate signed by the Treasurer in the land records of the town. In many respects these penalties closely resemble the penalties imposed for failure to pay the federal income tax. The court said: "The company was confronted with this situation: Though it contested the validity of the tax successfully it could not prevent the filing of the lien upon its property. And if it were unsuccessful, no matter what merit its claims possessed the lien would attach, and the 5 per centum penalty and the 9 per centum interest would accrue. The lien might prove a serious burden upon its credit, while the actual pecuniary losses suffered or threatened involved a hardship and loss which no company should be compelled to face. It could not measure the extent of these penalties, because it could not know the time the tax litigation would take. It would be unfair to it to compel it to take this risk of loss as the condition of its right to test the validity of the tax. It should have that right without condition, and by a clear and certain remedy. This is common practice, and it is sound public policy. It is not to the advantage of the state that those whom it seeks to tax should refuse to pay their taxes in order to test their validity. Such a course if largely followed might cause the state more than an inconvenience in the disturbance of the budget upon which the payment of its governmental obligations depended. The more orderly course is a compliance with the law by a payment, reserving the right to contest the validity of the required payment. The payment of the tax in question was not a voluntary one; it was in the contemplation of the law a payment under duress of the penalties of the act. And this we hold from a consideration of the provisions of the act and without a consideration of any remedies by way of distress which the state might have for the enforcement of payment of this tax. A payment of a tax made to avoid the onerous penalties of the act imposing the tax for its nonpayment is not a voluntary payment." (See also Home Tel. & Tel. Co. v. Los Angeles, [Cal.], 181 Pac. 815.)

the strict rule with regard to duress a taxpayer may not safely pay each installment on the fifteenth day of the various months so far as the technical requirements of a suit to recover taxes are concerned.[85]

PAYMENT AFTER RECEIPT OF FIRST NOTICE AND DEMAND FOR TAX. The earlier form[86] of notice and demand for tax contained the following language: "Demand is here made for this tax. * * * If this tax is not in my hands for deposit before the close of business of the day above specified it will become my duty, under the law, to collect the same together with 5 per centum additional, and interest at 1 per centum per month until paid." The form[87] in use from 1916 until recently contains the following language: "If payment is not made within ten days from the above date, it will be my duty to collect the same with costs by seizure and sale of property." The form now in use contains the language: "Demand is made for the payment of the said tax on or before the date given below. Failure to do so will cause a 5 per cent penalty to accrue with interest at 1 per cent per month from due date until paid."[88] In a case in which a notice very similar in form to the first of the above notices and containing a threat to collect penalties and interest was served upon the taxpayer it was held that payment was clearly involuntary and under duress.[89] In another case[90] arising under the 1913 Law the Supreme Court allowed recovery when payment was made after receipt by the taxpayer of the first of the above forms of notice. It is a matter of doubt whether the pres-

85 Neither should the tax be paid in advance, if it is objected to as illegal. For instance, payment of the four installments at the time of filing a return would probably preclude a taxpayer from relief in the courts. In Railway Co. v. Humboldt, 87 Kans. 1, 123 Pac. 727, the court stated that the payment of the second half of a tax, due in June, prior to December 20 of the preceding year, in order to obtain a rebate, was a voluntary payment and was therefore not recoverable.

86 Form 1-17.

87 Form 1-17.

88 See Form 1-17 in its latest revision.

89 Herold v. Kahn, 159 Fed. 608.

90 Gulf Oil Co. v. Lewellyn, 248 U. S. 71, reversing 245 Fed. 1, which had reversed 242 Fed. 709. In a case arising under the 1909 Law it was held that payment after a notice to the effect that if the tax together with interest was not paid, the collector would take steps to collect the same with penalties was involuntary. (Cambria Steel Co. v. McCoach, 225 Fed. 278.)

ent form of notice and demand, not containing an express threat to collect the 5% penalty and interest, and containing no reference to any seizure and sale of property, but containing a statement that such penalty and interest will accrue, is sufficient to constitute a payment made thereafter involuntary.

PAYMENT AFTER RECEIPT OF SECOND NOTICE AND DEMAND FOR TAX. There can be no doubt that payment upon receiving the second notice and demand is clearly payment under duress, since that notice threatens the seizure and sale of the taxpayer's property to satisfy the tax, penalty, interest and costs.[91] If the taxpayer delays payment until the receipt of such notice, in order that it may be shown that payment was clearly made under duress, penalty and interest must also be paid. It is a wise precaution in such case to protest not only against payment of the tax but also against payment of such penalty and interest as well.

Receipts for Payment of Tax. Every collector to whom any payment of any tax is made is on request required to give to the taxpayer a full written or printed receipt, stating the amount paid and the particular account for which the payment was made.[92]

FORM OF RECEIPT. The only official receipt for taxes that collectors may sign under the law is the form prescribed by the Department. However, there is no objection, on the part of the Department, to collectors signing commercial receipts or voucher checks, but they should in signing such receipts or vouchers write or stamp across the face thereof "not an official receipt." The official receipt must also be furnished, and an unofficial receipt is not in any manner binding on the government and will not be received by it as evidence of payment of the tax.[93] Deputy collectors must give taxpayers, at the time of the payment, a personal receipt stating that the amount of payment has been received to be forwarded to the collector.[94] In the case of payments by check or

91 See Form 1-21.

92 Revenue Act of 1918, § 251. Prior to the enactment of this section receipts were issued even when they were not requested. With regard to the penalty for the simulation of income tax receipts, see U. S. v. Pittaro, U. S. Dist. Ct., N. D. of Ohio. T. D. 2874.

93 T D. 2226.

94 T. D. 2341.

money order the canceled check or money order receipt is usually a sufficient receipt. In case of payments by cash the taxpayer should in every instance require receipt.[95]

TAXES WITHHELD AT THE SOURCE. Whenever any debtor pays taxes withheld at the source on account of payments made or to be made by him to separate creditors, the collector is required, on request, to give a separate receipt for the tax paid on account of each creditor so that the debtor can conveniently produce such receipts severally to his creditors in satisfaction of their respective demands up to the amounts stated in the receipts. Such receipts are sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount stated in the receipt. The creditor may, upon giving the debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting and specifying the amount of tax paid as a further satisfaction of the debt to that amount, require the surrender to him of the collector's receipt.[96]

Abatement and Refund. The taxpayer may file a claim for abatement of an assessment which he thinks is erroneous after the assessment has been made and before the tax is paid, or may file a claim for refund of a tax which he thinks has been erroneously assessed after the tax is paid. A further discussion of this subject is contained in a later chapter on abatement and refund.[97]

Additional Assessment. The 1916 Law provided[98] that "in cases of refusal or neglect to make a return and in cases of erroneous, false, or fraudulent returns, the Commissioner shall, upon the discovery thereof, at any time within three years after the return is due, or has been made, make a return upon information obtained as provided for in the law, or require the necessary corrections to be made, and in such cases the assessment made by the Commissioner thereon shall be paid by the taxpayer immediately upon notification of the amount of such assessment." The usual ten day period of grace, however, applied to such assessments as

95 Reg. 45, Art. 1021.
96 Revenue Act of 1918, § 251. See Chapter 40.
97 See Chapter 37.
98 Revenue Act of 1916, §§ 9 (a), 14 (a).

well as to the regular assessments. The same law provided:[99] "If any person * * * fails to make and file a return or list at the time prescribed by law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. Any return or list so made and subscribed by a collector or deputy collector shall be *prima facie* good and sufficient for all legal purposes. * * * The Commissioner of Internal Revenue shall assess all taxes, other than stamp taxes, as to which returns or lists are so made by a collector or deputy collector." The duplication and conflict of these provisions have been removed in the Revenue Act of 1918. It is now provided:[100] "If any person * * * fails to make and file a return or list at the time prescribed by law or by regulations made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner or by a collector or deputy collector and approved by the Commissioner, shall be *prima facie* good and sufficient for all legal purposes. * * * The Commissioner of Internal Revenue shall determine and assess all taxes other than stamp taxes, as to which returns or lists are so made under the provisions of this

99 R. S. 3176, as amended by the Revenue Act of 1916. Although the Commissioner had power summarily to assess the tax upon discovery of income which had not been reported, yet if such discovery was made prior to the day on which the tax was due (June 15th or in the case of the corporations filing for their fiscal year 165 days after the closing of the fiscal year) the tax could not be summarily assessed but might be paid at any time before the regular due date with an additional period of ten days of grace. (T. D. 2003.) Where a summary assessment was made after the regular due date, the tax was due immediately upon notice and demand given by the collector. (Reg. 33, Arts. 177 and 184.)

100 R. S., § 3176, as amended by the Revenue Act of 1918. The italicized words were added by the amendment.

section." The Revenue Act of 1918 also provides[101] that "except in the case of false or fraudulent returns *with intent to evade the tax,* the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due." In addition to removing the inconsistency of the two sections providing for summary assessment, the two last quoted provisions make three changes in the law. In the first place, the rule that the limitation of time is upon the discovery of the error by the Commissioner and not upon the making of the additional assessment,[102] is changed, and the limitation is now upon the making of the assessment.[103] In the second place, the limitation itself is extended from three to five years.[104] In the third place, the limitation which was held formerly to apply only to summary assessments[105] is now expressly made also applicable to "suits or proceedings for the collection of any tax."[106] Additional assessment may still be made where the erroneous return is due to an honest mistake, and where the mistake is not discovered until after the tax is assessed and has been paid in the regular course.[107]

FIVE-YEAR LIMITATION ON SUMMARY ASSESSMENT. The 1916 Law authorized the Commissioner to make a summary assessment of the tax on undisclosed income, if the discovery was made within three years after the return in which such income should have

101 Revenue Act of 1918, § 250 (d).

102 Eliot Nat. Bank v. Gill, 210 Fed. 933, affirmed 218 Fed. 600.

103 Revenue Act of 1918, § 250 (d).

104 Compare Revenue Act of 1918, § 250 (d) with Revenue Act of 1916, §§ 9 (a) and 14 (a).

105 U. S. v. Minneapolis Threshing Mach. Co., 220 Fed. 1019.

106 Revenue Act of 1918, § 250 (d). Compare this section with Revenue Act of 1916, §§ 9 (a) and 14 (a).

107 Eliot National Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. The same words "false or fraudulent" are still used in R. S. § 3176, as amended by the Revenue Act of 1918, which were held in the above cases to include returns honestly incorrect and thus to give the Commissioner power to make summary assessments when such returns had been filed.

been reported was due.[108] The assessment was not required to be made within three years, so long as the discovery was made within that time.[109] The three years' limitation in this provision was not a limitation upon the right of the government to sue for unpaid taxes, but was at most a limitation upon the right of the collecting officers to make assessment and enforce the payment by the summary statutory proceeding.[110] This three-year limitation still applies to additional assessments made under the 1913 and 1916 laws. The period of limitation is five years as to taxes assessed under the Revenue Act of 1918; the limitation is upon the making of the assessment, and is applicable to the right of the government to sue as well as to make summary assessment. In computing the five year period, March 15, the date on which the returns should have been filed, or were filed in due course, should be excluded. The more modern general rule [111] in the interpretation of statutes, where time is to be computed from a particular day, is to exclude the day thus designated and to include the last day of the

108 Revenue Act of 1916, §§ 9 (a) and 14 (a).

109 Eliot National Bank v. Gill, 218 Fed. 600. While the Government was fully authorized under the 1916 Law to recover taxes by suit upon discovery of liability to original or additional tax after the three-year period, the Treasury Department preferred that the collection should be made in the ordinary statutory method, that is, as a result of a formal assessment. In order that this might be done, taxpayers were requested to make amended returns and to execute waivers of the three-year statutory limitation. In executing such waiver, the taxpayers forfeited none of their rights and assumed no liability to any penalty that might not have been enforced against them in the absence of such waiver. If the taxpayer, against whom an additional tax liability was discovered, formally accepted the findings of the examining officer and agreed voluntarily to pay the tax, this amounted to a waiver and neither amended returns nor waivers were required. (Mimeograph Letter to Collectors, No. 1192.) There was apparently no objection to a taxpayer signing a waiver where additional tax liability was discovered after the expiration of the three-year period, providing he did not question the legality of the assessment. The result of signing a waiver was to compel him to pay the tax under protest and sue for its recovery, while if a waiver was not signed, the Government became the plaintiff in an action to collect such tax. Where the limitation of the statute as to assessment had run and a written waiver of exemption from assessment was given by the taxpayer, the *ad valorem* penalty of 50% addition to tax, was not assessed for delinquency in filing a return. (Reg. 33 Rev., Art. 52.)

110 U. S. v. Grand Rapids & Indiana Ry. Co., 239 Fed. 153.

111 McCullogh v. Hopper, 47 N. J. L. 189.

specified period.[112] The limitation discussed in this paragraph does not apply in case of false or fraudulent returns with intent to evade the tax.[113]

Refund of Taxes Collected on Second Assessment. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment will not be remitted, nor such taxes collected under such assessment refunded or paid back or recovered by any suit unless it is proved that such list, statement, or return was not willfully false or fraudulent, and did not contain any wilful understatement or undervaluation.[114]

Interest on Delinquent Taxes. Where the time for the payment of any installment of the tax is postponed at the request of the taxpayer, interest at the rate of 6 per cent per annum is added from the original due date. If an understatement of the tax in the return is due to the negligence of the taxpayer, but without intent to defraud, interest at the rate of 12 per cent per annum is added to the amount of the deficiency of each installment from the time the installment was due. If any tax remains due and unpaid for ten days after notice and demand by the collector, or in the case of the first installment as computed by the taxpayer remains due and unpaid for ten days, interest at the rate of 12 per cent per annum is added from the due date, except that the interest on any amount which is the subject of a *bona fide* claim for abatement shall be at the rate of 6 per cent per annum, and except that no interest is added in the case of estates of insane, deceased or insolvent persons. But if any part of a claim for abatement on the ground of a loss in inventory is disallowed, interest from the original due date at the rate of 12 per cent per annum will be added to the tax not abated; and interest is to be added in all cases in which the demand of payment is made of the

112 Eliot National Bank v. Gill, 218 Fed. 600; National Bank of Commerce v. Allen, 223 Fed. 472.

113 Revenue Act of 1918, § 250 (d).

114 R. S., § 3225 as amended by the Revenue Act of 1918. This amendment combines the former proviso clause of R. S., § 3220 with R. S., § 3225 in its previous form; and also by the insertion of the words "wilful" and "wilfully" is a statutory enactment of Northwestern Ins. Co. v. Fink, 248 Fed. 568. See p. 563.

taxpayer personally, although he subsequently dies, or becomes insane or insolvent, so that collection of the tax is made from his estate in the hands of his representative.[115] Where penalty has been added to a tax, interest is computed on tax and penalty,[116] and is recoverable as interest, not as penalty.[117]

Suits for Collection of Taxes. Prior to the Revenue Act of 1918 none of the statutes of limitations, such as the limitation of three years (now five years) as to summary assessments contained in the various income tax laws was applicable to suits by the United States to recover unpaid taxes or the balance of any unpaid tax, but at most was a limitation upon the right of collecting officers to make assessments and to enforce the tax by summary statutory proceedings.[118] This rule is now changed and the statute of limitation of five years is applicable to such suits.[119] As to taxes which have accrued under the 1916 Law and prior laws the Government may without limitation as to time bring suit, whether the taxes in question have been assessed or not, and whether or not they are assessable. The only qualification upon this right to resort to a plenary suit in the absence of an assessment is that the tax must be ascertainable and determinable, on evidence, by a court, and a tax of fixed percentage on a subject or object which is so definitely described in the statute that its amount or value can be so ascertained or determined, may be recovered in an action though it has never been fixed by an assessment. The action by the government to recover unpaid taxes may take the form of *indebitatus assumpsit,* or a common-law action of debt,[120] and should be brought in the name of the United States in the district within which the liability to the taxes is incurred or where the party from whom the taxes are due resides at the time of the commencement of the action. Interest on the taxes sued for runs

115 Reg. 45, Art. 1003; Revenue Act of 1918, § 250 (e).

116 T. D. 870, Feb. 27, 1905.

117 U. S. v. Guest, 143 Fed. 456.

118 U. S. v. Minneapolis Threshing Machine Co., 229 Fed. 1019.

119 Revenue Act of 1918, § 250 (d).

120 U. S. v. Nashville, etc., Ry. Co., T. D. 2697; U. S. v. Grand Rapids, etc., Ry. Co. (and cases cited) 239 Fed. 153; U. S. v. Minneapolis Threshing Mach. Co., 229 Fed. 1019; Dollar Savings Bank v. U. S.. 19 Wall. 227; King v. U. S., 99 U. S. 229; U. S. v. Chamberlin, 219 U. S. 250; U. S. v. Little Miami Co., 1 Fed. 700.

from the time the taxes were due.[121] No suit for the recovery of unpaid taxes or of any fine, penalty or forfeiture will be commenced until the collector has submitted to the Commissioner a full report of all material facts and circumstances in the case and received from him express authority to proceed.[122]

Lien for Unpaid Taxes. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount is a lien in favor of the United States from the time when the assessment-list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person.[123] In any case where there has been failure to pay the tax and it has become necessary to seize and sell real estate to satisfy it, a bill in equity may be filed in a district court of the United States to enforce the lien of the United States for tax upon any real estate in which the delinquent has any right, title or interest. This remedy does not supersede distraint, but is cumulative.[124]

NOTICE OF LIEN. The government's lien for collection of taxes is not valid as against any mortgagee, purchaser or judgment-creditor, until notice of such lien has been filed by the collector in the office of the Clerk of the District Court of the District within which the property subject to such lien is situated, and is not valid in a state which by appropriate legislation authorizes the filing of such notice in the office of the registrar or recorder of deeds of the counties of that state, unless the notice is filed in the office of such registrar or recorder of deeds of the county (or parish in the State of Louisiana) within which the property subject to the lien is situated.[125] A lien for taxes is not similar

[121] U. S. v. Erie R. R., 106 U. S. 327.

[122] Reg. 45, Art. 1008.

[123] R. S., § 3186.

[124] Reg. 45, Art. 1010.

[125] Act of March 4, 1913, amending R. S., § 3186. This amendment seems to have been made in response to suggestions of the American Bar Association (Part 1, Proceedings American Bar Ass'n. 106 p. 598) and of the court in U. S. v. Curry, 201 Fed. 371, in which the harshness of enforcing the lien against innocent purchasers without knowledge or notice of the lien was emphasized. (See also U. S. v. Pacific R. R., 1 Fed. 97.) The suggestion was made by Judge Rose in the Curry case in the following language. "It would seem that by a comparatively slight change of the statute law the rights of the

to the lien of an ordinary incumbrance. It is not displaced by a sale under a pre-existing judgment or decree, unless otherwise directed by statute. It attaches to the *res* without regard to individual ownership, and when it is enforced by sale pursuant to the statute prescribing the mode of assessing and collecting taxes, the purchaser takes a valid and unimpeachable title.[126] The lien may be enforced against any transferee of real or personal property of the taxpayer (except a mortgagee, purchaser or judgment creditor) with respect to property transferred after the lien attaches, that is, after the filing of the list with the collector, although the transferee had no notice of the lien.[127] To create a lien demand must be made for a specific amount; all steps required by law must be pursued strictly. The lien requires an assessment, a notice of the tax due, and a specific demand upon the individual taxpayer for payment.[128] The government is not compelled to resort to distraint and sale of chattels and personal effects of a taxpayer, before instituting proceedings to enforce a lien on the taxpayer's real estate and leaseholds.[129]

TIME WHEN LIEN ATTACHES. The statute expressly provides that a lien for unpaid taxes in favor of the United States shall attach from the time when the assessment-list was received by the collector, except when otherwise provided.[130] No other provision seems to be applicable to the income tax law. The Revenue·Act of 1918 provides that "all administrative special or stamp provi-

United States could be sufficiently protected without endangering the interests of other persons. The collector of internal revenue at the time he makes a demand upon the taxpayer might be required to transmit a copy of the demand to some office in which judgments and other recognized liens upon real estate are recorded and the records of which are consequently carefully examined by conveyancers." The lien was held to be superior to that of any one acquiring any interest in the property after the date of demand and unaffected by the fact that a subsequent purchaser became such without knowledge of the lien or claim of the government in the following cases: U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Turner, 28 Fed. Cas. No. 16,548; U. S. v. Snyder, 149 U. S. 210; U. S. v. Blacklock, 208 U. S. 75.

126 Osterberg v. Union Trust Co., 93 U. S. 424.

127 U. S. v. Curry, 201 Fed. 371 (and cases cited) is modified by the amendment of R. S., § 3186.

128 U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Allen, 14 Fed. 263.

129 U. S. v. Curry, 201 Fed. 371; Mansfield v. Excelsior Refining Co., 135 U. S. 326; U. S. v. Blacklock, 208 U. S. 75.

130 R. S., § 3186.

sions of law including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act.'' But under the method of collection prescribed by that law it is uncertain when the assessment list is intended to reach the collector.[131] In the case of a corporation which has distributed its assets prior to the time when a lien would attach thereto, the government may proceed to collect the tax as a general creditor.[132]

Taxes Collectible by Distraint. If any person liable to pay any taxes neglects or refuses to pay the same within ten days after notice and demand, it shall be lawful for the collector or his deputy collector to collect the taxes, with the 5% penalty, and interest at the rate of 1% per month, by distraint and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, of the person delinquent.[133] This section of the statute exempts certain property from distraint in the case of the head of a family.[134] Extensive provision is made in the statute for the mode of levying distraint and proceedings on distraint.[135] Collectors are enjoined against unnecessary delays in making sales and postponing sales beyond statutory periods; they are also required to make reports promptly.[136] Surplus moneys must be deposited as internal revenue collections and cannot be returned to the legal owner of the property sold.[137] In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, the sum of $5 is added as part of the tax.[138] The power to distrain personal property for payment of taxes is almost as old as the common law. It is also competent for Congress to apply to realty as well as personalty the power to distrain and sell when necessary to enforce

131 Revenue Act of 1918, § 250. See Reg. 45, Art. 1012, which states that ''when the returns are received at the collector's offices, they are examined and listed before being forwarded to the Commissioner.''

132 See Chapter 10.

133 R. S., § 3187.

134 Only heads of families are entitled to this exemption. (T. D. 1499.) The state exemption laws are inapplicable to debts due the United States—U. S. v. Howell, 9 Fed. 674.

135 R. S., § 3188 et seq.

136 T. D. 623, January 23, 1903.

137 T. D. 1373.

138 Revenue Act of 1918, § 250 (f).

the payment of the tax. It is only the further legitimate exercise of the same power for the same purpose.[139] When goods, chattels or effects sufficient to satisfy the taxes imposed upon any person are not found by the collector or deputy collector, he is authorized to collect such taxes by seizure and sale of real estate. Distraint may also be used against a delinquent collector.[140]

Procedure in Case of Taxpayers Contemplating Removal or Concealment of Property to Defeat Collection of Tax. If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner may declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In such a case the taxpayer is entitled to a full personal exemption and credit for dependents. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A person who is not in default in making returns or in paying other taxes may procure the postponement until the usual time of the payment of taxes declared or declarable to be due as above indicated by depositing with the Commissioner United States bonds of a principal amount double the estimated amount of taxes due from such person for the taxable year or by furnishing such other security as may be approved by the Commissioner. The Commissioner may approve and accept in like manner secur-

139 Springer v. U. S., 102 U. S. 586.
140 Reg. 45, Art. 1009.

ity for return and payment of taxes made due and payable by virtue of the above finding and declaration, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him. If security is approved and accepted and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any of the above proceedings prior to the expiration of the time otherwise allowed for paying such respective taxes.[141] Under this provision it seems to be within the power of the Commissioner to declare the taxable period of a corporation terminated at the end of the calendar month preceding the month in which it is dissolved and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment thereof.

Committee on Review and Appeal. An Advisory Tax Board was created by the Révenue Act of 1918 for the reasons, and with the organization and powers indicated elsewhere in this book. In regard to the submission of questions to and procedure before such board the Treasury Department has ruled as indicated in the following paragraphs. This Board was subsequently dissolved but its work was taken over and carried on by the Committee on Review and Appeal.[142]

SUBMISSION OF QUESTIONS TO COMMITTEE ON REVIEW AND APPEAL. Questions relating to the interpretation or administration of the income tax and war-profits and excess-profits tax laws may be submitted to the Committee on Review and Appeal by the Commissioner on his own initiative or at the request of any taxpayer directly interested for the purpose of obtaining the recommendation of the Committee thereon. When a final conclusion has been reached by the income tax unit of the Internal Revenue Bureau as to the disposition of a matter, any taxpayer directly interested therein may request the Commissioner to submit such matter to the Committee. In the case of matters arising in connection with the audit of a taxpayer's return the taxpayer will ordinarily be notified of such conclusion prior to assessment by letter. The taxpayer should file with the Commissioner (to be

141 Revenue Act of 1918, § 250 (g); Reg. 45, Art. 1013.
142 See p. 5.

transmitted to the income tax unit) a request in writing for submission with a statement of his objections to the conclusion of the unit and the reasons for such objections. Such request and statement must be filed with the Commissioner within thirty days after the taxpayer has been notified of the conclusion of the income tax unit or within such longer period as the Commissioner may allow, but the Committee may at its discretion at any time receive additional statements of objections or reasons therefor.[143]

PROCEDURE BEFORE COMMITTEE ON REVIEW AND APPEAL. Matters submitted to the Committee on Review and Appeal will ordinarily be considered upon the papers, but a hearing for oral presentation of a case will be granted whenever the Committee deems such hearing necessary for the proper disposition thereof. Matters will ordinarily be considered upon the facts presented to the income tax unit. New evidence will not ordinarily be received by the Committee, but matters will be recommitted to the income tax unit for further presentation of facts. Oral or written evidence may, however, be received by the Committee whenever it deems such action necessary for the protection of the Government or the prevention of injustice to the taxpayer. Decisions by the Committee upon matters referred to it at the request of taxpayers will be transmitted to the Commissioner.[144]

143 Reg. 45, Art. 1701.
144 Reg. 45, Art. 1702.

CHAPTER 36

PENALTIES AND COMPROMISES.

Several penalties are contained in the law for failure to comply with its provisions and for making false and fraudulent returns. The penalties take two forms: (a) specific penalties of fines with maximum limits and imprisonment, and (b) penalties of either 5%, 25% or 50% based upon the tax. In the case of individuals specific penalties are held to attach to the person and are unenforceable after the death of such person. *Ad valorem* penalties (those based upon the tax) are enforceable regardless of the death of the owner of the income by which the penalty is measured.[1] An *ad valorem* penalty is assessed and collected as a part of the tax, while a specific penalty is recoverable only by suit.[2]

Suit to Enjoin Collection of Penalties. While the prohibition of suits to enjoin the collection of internal revenue taxes[3] does not specifically include "penalties" as such, yet where penalties are authorized by the statute to be added to the tax and collected as a part of the tax, the courts hold that the penalty is a part of the tax, and that its collection cannot be enjoined.[4]

Failure to File Return. If an individual, corporation or partnership fails to file a return, the specific penalty, where the failure is not wilful, is not more than $1,000.[5] In the case of such failure to file a return or list within the time prescribed by law, or by the Commissioner or collector, the Commissioner also adds to the tax 25% of its amount,[6] except as set forth in the next paragraph. Two classes of delinquents are liable to the penalty:

1 Reg. 33 Rev., Art. 51. See U. S. v. Theurer, 213 Fed. 960; U. S. v. Pomeroy, 152 Fed. 279, reversed on different ground, 164 Fed. 324.

2 Reg. 45, Art. 1041.

3 R. S., § 3224.

4 Kohlhamer v. Smietanka, 239 Fed. 408.

5 Revenue Act of 1918, § 253.

6 R. S., § 3176, as amended by the Revenue Act of 1918.

(a) those who do not file returns and for whom returns are made by the collector or Commissoner; and (b) those who file tardy returns and are unable to show reasonable cause for the delay.[7]

EXCEPTION. When a return is filed after the time prescribed by law, and it is shown that the failure to file it was due to a reasonable cause and not to wilful neglect, the addition of 25% of the tax is not made.[8] Taxpayers wishing to avoid the penalty must make an affirmative showing of the facts alleged as a reasonable cause for failure to make a return on time in the form of an affidavit under oath, which should be attached to the return. If such an explanation is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the Commissioner, will forward the affidavit with the return, and if the Commissioner determines that the delinquency was due to a reasonable cause the 25 per cent penalty will not be assessed. "Reasonable cause" is such a condition of fact that had the taxpayer in default exercised ordinary business care and prudence it would have been impracticable or impossible for him to file a return in the prescribed time.[9]

Intentional Neglect or Refusal to Make Returns. Any individual, corporation or partnership wilfully refusing to make a return is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[10] In case of intentional neglect or refusal to make a return, the *ad valorem* penalty of 25% of the tax is also added. The amount so added is collected at the same time and in the same manner and as part of the tax, unless the tax has been paid before the discovery of the neglect, in which case the amount so added is collected in the same manner as the tax.[11]

[7] Reg. 45, Art. 1004.

[8] R. S., § 3176, as amended by the Revenue Act of 1918.

[9] Reg. 45, Art. 1004; Reg. 33 Rev., Art. 54.

[10] Revenue Act of 1918, § 253.

[11] R. S., § 3176, as amended by the Revenue Act of 1918; Reg. 45, Art. 1004. Under the 1913 Law the *ad valorem* penalty of 100% was added. (T. D. 1950.) R. S., § 3176 as then in force did not except from the 50% penalty the case of a return filed after the time prescribed where it was shown that "the failure to file a return only the 25% penalty should be added. Even in the exception contained in R. S. § 3176, as amended by the 1916 Law, and the Revenue Act of 1918, and the inference of which is clear that for intentional

False Returns. The law provides that if an understatement in a return "is false or fraudulent, then, in lieu of the penalty provided by Section 3176 of the Revised Statutes, as amended, for false or fraudulent returns wilfully made, but in addition to other penalties provided by law for false or fraudulent returns there shall be added as part of the tax 50 per centum of the amount of the deficiency."[12] This provision does not seem to include returns which are false in the sense of containing mistakes or unintentional misstatements. A return may be false, in the sense used in those sections of the law which permit summary assessments in the case of erroneous, false or fraudulent returns without being false in the sense of the section prescribing the penalty of 50%.[13] If a return made in good faith is false in the sense of being incorrect, but such falsity is due to negligence on the part of the taxpayer, the 50% is not added, but a penalty of 5% of the total amount of any deficiency plus interest at 1% per month on the amount of the deficiency of each installment from the time such installment is due, is added. No penalty is imposed in case a return made in good faith is false in the sense of being incorrect, in the absence of fault on the part of the taxpayer.[14] In general, negligence is attributable to the taxpayer if he computes the tax in disregard of the instructions on the return form or otherwise incorrectly, unless he can show that his error was due to an honest misunder-

failure to file a return only the 25% penalty should be added. Even in the 1913 form, however, it is difficult to understand by what authority the 100% penalty was added for failure to make any return at all, even though the failure was intentional.

12 Revenue Act of 1918, § 250. The law also provides that "in case a false or fraudulent return is wilfully made, the Commissioner shall add to the tax 50 per centum of its amount." The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity or fraud, in which case the amount so added shall be collected in the same manner as the tax. (R. S. § 3176, as amended by Revenue Act of 1918. See also Reg. 45, Art. 1005.) Under this provision before the Revenue Act of 1918, it was held that the corresponding penalty should be added to the amount of the tax shown by the correct return. (Reg. 33 Rev., Art. 53.)

13 Revenue Act of 1918, § 250; R. S. § 3176, as amended by Revenue Act of 1918. Eliot Nat. Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. See, however, U. S. v. Nashville etc. Ry. Co., T. D. 2697.

14 Revenue Act of 1918, § 250.

standing of the facts or the law of which an average reasonable man might be capable.[15] In addition to the *ad valorem* penalties above enumerated for making false and fraudulent returns, a specific penalty not exceeding $1,000, or imprisonment not exceeding one year, or both, in the discretion of the court with costs of prosecution may be added.[16]

Fraudulent Returns. Where a false or fraudulent return is made, then, in addition to the other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50% of the amount of the deficiency. This increase is only made in case the return is fraudulently false.[17]

Fine Against or Imprisonment of Officer of Corporation or Member of Partnership or Employee of Either. In case an officer of a corporation or member of a partnership or an employee of either, charged with the duty and responsibility of making a return, paying or collecting the tax, or supplying information at the source, wilfully refuses to make such return, pay or collect such tax, or to supply such information, or attempts in any manner to defeat or evade the tax, he is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[18]

Returns of Information at Source. Any individual, corporation or partnership called upon to supply information at the source, who fails to do so at the time or times specified in each year, when such failure is not wilful, is liable to a penalty of not more than $1,000. If such failure to file information at the source is wilful, the delinquent is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[19]

15 Reg. 45, Art. 1005.

16 The making of a false or fraudulent return might also fall within the provisions of Section 253 of the Revenue Act of 1918 which imposes a fine of not more than $10,000 and imprisonment for not more than one year, or both, together with the costs of prosecution for wilfully attempting "in any manner to defeat or evade the tax."

17 Nat. Bank of Commerce v. Allen, 223 Fed. 472.

18 Revenue Act of 1918, § 253.

19 Revenue Act of 1918, § 253.

Returns of Withholding Agents. Failure to make and file withholding returns on or before March 1st renders a withholding agent liable to the specific penalty of not more than $1,000[20] unless the tax is paid by the recipient of the income.[21] If the failure of the withholding agent was fraudulent and for the purpose of evading the tax, however, he will be guilty of a misdemeanor and fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution, irrespective of whether or not the tax is paid by the recipient of the income.[22] The 25% addition to the tax for failure to make a return and the 50% addition for a wilfully false and fraudulent return are not assessed against withholding agents.[23]

Attempts to Evade the Tax. Any individual, corporation or partnership wilfully attempting in any manner to defeat or evade the tax is guilty of a misdemeanor and may be fined not more than $10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution.[24]

Failure to Pay Tax. Any individual, corporation or partnership failing wilfully or otherwise to pay the tax at the time or times required is liable to the same specific penalties which attach for failure to make a return accordingly as such failure is or is not wilful.[25] In addition, as set forth in another chapter[26] interest will be added, the tax will become a lien, and the goods, chattels or effects, including stocks, securities and evidences of debt, of the taxpayer will be subject to distraint and sale.

Delay in the Payment of the Tax. As a general rule, if any

20 Revenue Act of 1918, § 253.

21 Revenue Act of 1918, § 221 (e).

22 Revenue Act of 1918, §§ 253, 221 (e).

23 Mimeograph letter to Collectors, No. 1,265.

24 Revenue, Act of 1918, § 253. The following comment of Mr. Justice Holmes in Bullen v. Wisconsin, 240 U. S. 625, is interesting in this connection: "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."

25 Revenue Act of 1918, § 253.

26 See Chapter 35.

tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, there will be added as part of the tax the sum of 5% on the amount due but unpaid, and interest at the rate of 1% per month upon such amount from the time it became due. This penalty and interest do not accrue in case of any tax due from the estates of insane, deceased or insolvent persons. When an assessment has been made for a tax or penalty and a *bona fide* claim for its abatement is filed within ten days after demand for payment, the time ceases to run against the claimant as to the 5% penalty, from the time the tax was due until the claim is decided. Upon receipt of a notice of rejection of the claim or so much thereof as is not allowed the collector will notify the claimant and demand payment of the tax. If the tax is not then paid within 10 days, the 5 per cent penalty will be assessed on the amount of tax not abated. If abatement of the entire tax assessed is not demanded in a claim, and the balance of the tax is not paid within the required 10 days, the 5 per cent penalty will immediately accrue on such balance.[27] Interest at the rate of ½ of 1% per month, in any event, will run from the time the tax was due until the claim is decided, notwithstanding that a claim for abatement has been filed.[28] Where a warrant of distraint is served, $5 is added.[29]

Penalty for Divulging Information. The penalty in the case of any collector, deputy collector, agent, clerk or other officer or employee of the United States who divulges information in his possession and acquired in the performance of his duties, is treated elsewhere in this book.[30]

Statute of Limitations. The Revised Statutes provide that no suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. The statute

27 Revenue Act of 1918, § 250 (d); Reg. 45, Art. 1006; Reg. 14, October 15, 1916; Reg. 1., p. 110.

28 Revenue Act of 1918, 250 (d). See Chapter 37.

29 Reg. 45, Art. 1006.

30 T. D. 2903; R. S. § 3167, as amended by Revenue Act of 1918. See Chapter 35.

does not run, however, if the person liable for the penalty is not to be found within the United States so that proper process may be instituted and served against him.[31] The period of limitation applies whether the action is *in personam or in rem.*[32] The courts have no power to engraft any exception on this statute in cases of concealed fraud which is not discovered until after the expiration of five years.[33] The States cannot pass any statute of limitations which will bind the Federal Government, or which will furnish the rules for determining whether an action is brought in time, except as Congress has clearly manifested its intention that the United States shall be so bound.[34]

Compromise of Penalties. The Commissioner, with the advice and consent of the Secretary, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon; and, with the advice and consent of the said Secretary, and the recommendation of the Attorney General, he may compromise any case after a suit thereon has been commenced. Whenever a compromise is made in any case the opinion of the Solicitor of Internal Revenue or of the officer acting as such, with his reasons therefor, with a statement of the amount of tax assessed, the amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and the amount actually paid in accordance with the terms of the compromise, must be placed on file in the office of the Commissioner.[35] The Commissioner has under this section no power to compromise a suit against the government,[36] the power being limited to suits which the government may prosecute. A compromise operates for the protection of the offender against subsequent proceedings as fully as a formal conviction or acquittal, and is a bar to further action.[37] Where an action is brought by the United States against a delinquent taxpayer for having failed to file a

31 R. S., § 1047.

32 Hatch v. The Boston, 3 Fed. 807, 810.

33 U. S. v. Maillard, 26 Fed. Cas. No. 15,709.

34 Arnson v. Murphy, 109 U. S. 238; U. S. v. Nashville Rd. Co., 118 U. S. 125.

35 R. S., § 3229; See § 3469, as to compromise of cases after judgment. See opinion Atty. General, dated June 3, 1919; I. T. S. 1919, ¶ 3529.

36 23 Op. Atty. Gen. 507.

37 U. S. v. Chouteau, 102 U. S. 603; Rau v. U. S., 260 Fed. 131.

return, the verdict must specifically state the amount of the penalty, after which the only remedy of the defendant (other than an appeal) is to apply for a compromise.[38] Offers in compromise should include payments of costs.[39] The amount of the offer should be deposited with the Commissioner, but cannot be held or set off against the tax due.[40] Refunds cannot be made of offers in compromise where it is subsequently ascertained that no violation of law was involved.[41]

SPECIFIC PENALTIES. While the sections of the Revised Statutes relating to compromise[42] do not in express language refer to the compromise of the specific penalty for failure to file the return, neither are they restricted in terms, nor by any reason of public policy, to penalties for the non-payment of taxes. In the opinion of the Attorney General the application of these sections to the compromise of penalties for failure to file returns in time is proper, and, further, in such compromises the Commissioner is authorized to consider not only the pecuniary interests of the Treasury, but also general considerations of justice, equity and public policy.[43]

AD VALOREM PENALTIES. Congress has left it to the judgment and discretion of the Commissioner to determine when it is to the interest of the United States to compromise the *ad valorem* penalties imposed for failure to file returns, for false and fraudulent returns, for non-payment of taxes when due, and interest, instead of commencing or prosecuting suits therefor. The only limitation placed upon the exercise of this judgment and discretion is that the Commissioner's action shall be with the advice and consent of the Secretary of the Treasury, and Attorney General (if suit has been commenced). Subject to this limitation the Commissioner has power to compromise such penalties and interest whenever in his judgment, such a compromise is for the interest of the United States. Congress has not said that such compromises may be made only when in the judgment of the Commissioner more money can thereby be realized than can be

38 U. S. v. Acorn Roofing Co., 204 Fed. 157.
39 T. D. 642, March 20, 1903.
40 Boughton v. U. S., 12 Ct. Cls. 330.
41 Reg. 45, Art. 1011.
42 R. S., §§ 3229 and 3469.
43 29 Op. Atty. Gen. 217.

realized by commencing and prosecuting a suit. It cannot be said, therefore, as a matter of law, that the power to compromise is limited to cases in which either the liability for the penalty or the collectibility of the claim is doubtful. The judgment of the Commissioner as to what is for the interest of the United States is conclusive, and what considerations shall control depend upon his discretion and sound judgment exercised in good faith. It may be that with respect to the amount of tax to be collected or the amount of penalty resulting from wilful fraud, the Commissioner may never find a case in which he will feel justified in accepting less than can be legally collected, whereas in cases of penalties resulting from accident, negligence, or technical omission he may honestly believe that the interest of the United States will be best served by accepting less than the full penalty. In such case he has the right to compromise upon any ground which in his judgment renders the compromise for the interest of the United States.[44]

OFFERS IN COMPROMISE. When returns of income or returns of information at the source are filed after their due dates, the specific penalty will be asserted unless it can be shown that the delay was due to a reasonable cause, and offers in compromise will be accepted in minimum amounts as follows: (1) Delinquent returns of income and information by individuals, $5; and (2) delinquent returns of income by corporations, $10. Such offers will only be received where the neglect of the taxpayer was not intentional.[45] Offers in compromise do not receive fa-

44 Opinion of Attorney-General dated June 3, 1919; I. T. S. 1919, ¶ 3529. See T. D. 2871. A penalty (50%) corresponding to the penalty of 25% increase in tax for failure to file returns is found in practically all revenue laws relating to special taxes, and one construction has been that no administrative officer is clothed with authority to compromise such increase in tax. (T. D. 1701.) It has been held that the income tax law is explicit and mandatory in its provisions relative to the additional assessment of 25% of the tax otherwise due, in case of failure to file a return of income within the prescribed time except when a return is filed after such time and it is shown that the failure was due to reasonable cause and not to wilful neglect, does not give discretionary authority for remission of these additional taxes to any officer of the government. Congress passed an act providing particularly for the refund of such additional taxes, assessed under the 1909 Law, for neglect to file returns, but no such statute has been passed with respect to penalties incurred under the 1913, 1916, or 1918 laws. (Act of March 3, 1913.)

45 Mimeograph Letter to Collectors, No. 2077, dated March 13. 1919. Cards,

vorable consideration in cases where returns for the year in question have not been filed, but such offers are accepted "subject to the filing of the return."[46] All delinquents who do not compromise their liabilities to the specific penalty, after ample opportunity, are reported to the United States District Attorney for proceedings.[47] It is the duty of every District Attorney to prosecute every case for the collection of a fine, penalty or forfeiture reported to him by any collector, unless, upon inquiry and examination, he decides that such proceedings cannot properly be sustained, or that the needs of public justice do not require that such proceedings be instituted; in which case he reports the facts to the Commissioner for his direction.[48] Under the 1864 Law as amended in 1870 only one penalty was permitted to be recovered for all failures to make a return prior to the commencement of the action for the collection of a penalty.[49]

Form 7245A, prepared in the manner indicated in Mim. 1480, dated February 26, 1917, should accompany every original delinquent return filed after the last dates for filing returns before the specific penalty will be asserted. (See also Mimeograph Letters to Collectors, No. 1480, dated February 26, 1917; T. D. 2311; T. D. 2349.)

[46] T. D. 2311.

[47] T. D. 2311.

[48] R. S., § 838.

[49] U. S. v. Brooklyn etc. Ry. Co., 14 Fed. 284; U. S. v. N. Y. Guaranty Co., 8 Ben. 269.

CHAPTER 37

ABATEMENT, REFUND AND RECOVERY OF TAXES

The prompt collection of the revenue and its faithful application is one of the most vital duties of government. Depending, as the government does, upon its revenue to meet not only its current expenses, but to pay the interest on its debt, it is of the utmost importance that it should be collected with despatch, and that the officers of the Treasury should be able to make a reliable estimate of means in order to meet liabilities. It would be difficult to do this, if the receipts paid into the Treasury were liable to be taken out of it, on suits for alleged errors and mistakes, concerning which the officers charged with the collection and disbursement of the revenue had received no information. To guard against such consequences, Congress has from time to time passed laws on the subject of the revenue, which not only provide for the manner of its collection, but also point out a way in which errors can be corrected. These laws constitute a system which Congress has provided for the benefit of those persons who complain of illegal assessments of taxes and illegal exactions of duties. The party aggrieved can test the question of the illegality of an assessment or collection of taxes by suit; but he cannot do this until he has taken an appeal to the Commissioner. In other words, the person who believes he has suffered wrong at the hands of the collector can appeal to the courts; but he cannot do this until he has taken an intermediate appeal to the Commissioner, and, in any event, he is barred from bringing a suit, unless he does it within the period limited by law. The object of these different provisions is apparent. While the government is desirous of securing to the citizen a mode of redress against erroneous assessments or collections, it says to him: "We want all controverted questions concerning the revenue settled speedily, and if you have complaint to make, you must let the Commissioner know the grounds of it; but if he decides against you, or fails to decide at all, you can test the question in the courts if you bring your suit

within a limited period of time."[1] The Commissioner, subject to regulations prescribed by the Secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed, or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected.[2] The Revenue Act of 1918 contains a new provision authorizing the crediting against any income, war-profits or excess-profits taxes due, or any installment thereof, of any amount of income, war-profits or excess-profits taxes paid in excess of that due under the Act of August 5, 1909, the Act of October 3, 1913, the Revenue Act of 1916, as amended, or the Revenue Act of 1917. It also authorizes the immediate refunding of any balance of such excess payment.[3]

Taxes Paid on Second Assessment. When a second assessment is made in case of a list, statement, or return, which, in the opinion of the collector, or deputy collector, was false or fraudulent, or contained any understatement or undervaluation, such assessment will not be remitted, nor will taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return, was not willfully false or fraudulent, and did not contain any willful understatement or undervaluation.[4]

Who May Claim Recovery of Tax. As a general rule, the taxpayer against whom the tax is assessed and by whom the tax is paid is the one who is entitled to claim abatement or refund or sue for its recovery. If the person against whom the tax is assessed is dead, the claim should be made in the name of the execu-

1 U. S. v. Real Estate Savings Bank, 104 U. S. 728. See also Nichols v. U. S., 7 Wall. 122, modified in regard to its holding that cases under the revenue laws were not within the jurisdiction of the Court of Claims in U. S. v. Kaufman, 96 U. S. 567 and U. S. v. Real Estate Saving Bank, 104 U. S. 728.

2 R. S., § 3220, as amended by the Revenue Act of 1918 by striking out the words "on appeal made to him (Commissioner of Internal Revenue)."

3 Revenue Act of 1918, § 252. As to the effect of this provision upon the former statute of limitations, see pp. 527, 567.

4 R. S., § 3225 as amended by the Revenue Act of 1918. This amendment combines the former proviso clause of R. S. § 3220 with R. S. § 3225 in its previous form; and also by the insertion of the words "wilful" and "wilfully" is a statutory enactment of the decision in Northwestern Mut. Life Ins. Co. v. Fink, 248 Fed. 568. The Government has withdrawn from the position taken by it in Camp Bird Ltd. v. Howbert, 249 Fed. 27, and the case has been dismissed in the Supreme Court.

tor or administrator.[5] In cases where the tax has been withheld at the source the claim for abatement or refund may be made either by the withholding agent against whom the assessment was made or by the person for whose account such taxes were withheld.[6] Where one corporation had leased all of its property to another, a tax being thereafter assessed upon the lessor, and its claim for an abatement being rejected, the tax was paid by the lessee to avoid the penalty threatened by the collector and to avoid distraint and sale of the leased property. The court held that the payment by the lessee was not voluntary and that it was entitled to sue for its recovery without regard to privity of contract between it and the collector.[7]

Abatement. Two forms are provided for the purpose of refund and abatement. One is made applicable to the return of taxes and penalties illegally or improperly assessed and paid, and the other to an abatement of their assessment. The former is applicable to cases where the taxes and penalties have been paid, and the latter to cases where they have not been paid. These regulations of the Secretary have the force of law, and the Federal Courts are obliged to take notice of them. Furthermore, they are obviously binding upon the Commissioner and he obtains jurisdiction to pass upon a claim only when they have been complied with. The merits of a case come before him when a proper claim has been made. Under a claim for abatement he can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction.[8] The Commissioner possesses no equity powers in case of abatement; if the tax is a legal one he cannot abate it.[9] It seems that the Commissioner has no authority to revoke the abatement of a tax once made by him, but he may re-assess the tax.[10]

5 Reg. 33 Rev., Art. 266. Certified copies of the letters of administration, letters testamentary or other similar evidence should be annexed to the claim in such case.

6 Reg. 33, Art. 33.

7 Cambria Steel Co. v. McCoach, 225 Fed. 278.

8 Hastings v. Herold, 184 Fed. 759. For a full discussion of the force and effect of the departmental rulings and regulations of the Secretary see Chapters 47 and 1.

9 Decision No. 180, 36 Int. Rev. Rec. 13.

10 U. S. v. Alexander, et. al., 110 U. S. 325.

Effect of Rejection of Claim for Abatement. By weight of authority it seems that, if an appeal is taken from an assessment and decided against the appellant, and the tax is afterwards collected, it is not necessary to take a second appeal for refund of the payment before commencing suit to recover the tax.[11] When the abatement claim has been considered and rejected upon its merits, no claim for refund is necessary to lay foundation for a suit.[12] In a recent case it was said: "What the Commissioner of Internal Revenue thought about the assessment had been obtained upon full statement of the facts, and it would have been a useless form again, after the tax was paid, to appeal to the Commissioner and obtain the same judgment. The reason for the appeal did not exist, and hence the appeal after the tax was paid was not necessary."[13] This seems to be the general rule, but it has also been held to the contrary that under a claim for abatement the Commissioner can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction, and where the abatement was rejected, but no application was made for refund after paying the tax, it has been held that a suit could not be maintained.[14]

Procedure for Claiming Abatement. Claim for abatement of taxes or penalties erroneously or illegally assessed, or which are abatable under remedial acts, etc., must be made out on the form prescribed by the government[15] and must be sustained by the affidavits of the parties against whom the taxes were assessed, or of other parties cognizant of the facts.[16] The practice is to obtain the official form from the local collector, prepare it according to instructions and file it with the local collector. The claim for abatement can only be made between the time the tax is assessed and the date it is due. If the claim has not been acted upon within ten days after notice and demand for the tax, 5% penalty for fail-

11 San Francisco Savings Society v. Cary, 2 Sawy 393.

12 DeBary v. Dunne, 162 Fed. 961; Schwarzschild & Sulzberger Co. v. Rucker, 143 Fed. 656; T. D. 974; Grier v. Tucker, 150 Fed. 658; T. D. 1293; Contra, Hastings v. Herold, 184 Fed. 759.

13 Weaver v. Ewers, 195 Fed. 247.

14 Hastings v. Herold, 184 Fed. 759. The weight of authority seems to be contrary to the rule in this case.

15 The form prescribed by the Government is known as Form 47.

16 Reg. 45, Art. 1032. Reg. No. 14 Rev. October 15, 1911, as modified by T. D. 2654.

ure to pay the tax will not accrue if the tax is paid within ten days after the claim for abatement is rejected, and interest from the time the amount was due until the claim is decided will be at the rate of ½% per month instead of one per cent. The rule waiving penalty and reducing interest obtains only as to any amount of tax which is the subject of a *bona fide* claim for abatement.[17] When a tax has been assessed and turned over to the collector, the presumption is that the assessment is correct. The burden of proof in rebutting the presumption and showing that it was improperly or illegally assessed, or that relief should be given under a remedial statute, rests upon the applicant for abatement. The affidavits must therefore contain full and explicit statements of all the material facts relating to the claim in support of which they are offered and to the proper consideration of which they are essential. The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by a claim for refund.[18]

Refund. Where the Commissioner, in a case within the scope of his authority and jurisdiction, has ordered a refund, a court cannot inquire as to the sufficiency of the evidence before him,[19] and neither the Comptroller of the Treasury nor any accounting officer has authority to review the Commissioner's decision.[20] Decisions by the Commissioner, in cases where a refund is directed, are binding and, in the absence of fraud, or mistake of calculation, not subject to revision.[21] The Commissioner's decision is conclusive as to the questions of fact,[22] but apparently not as to questions of law.[23] His decisions are in the nature of awards made by arbitrators, and generally speaking bind both the claim-

17 Revenue Act of 1918, § 250 (e).

18 Reg. 45, Art. 1032.

19 Woolner v. U. S., 13 Ct. Cls. 355.

20 Bank of Greencastle v. U. S., 15 Ct. Cls. 225. In Sybrandt v. U. S., 19 Ct. Cls. 461, it was held that even three adverse decisions of successive Secretaries would not prevent a Commissioner from taking up and allowing a claim for the refund of taxes.

21 Dugan v. U. S., 34 Ct. Cls. 458.

22 U. S. v. Wright, 11 Wall. 648.

23 Comp. Dec. 259.

ant and the Government. A refund may be impeached for fraud, want of jurisdiction, mistake apparent in the certificate, or for such irregularities as would avoid an award.[24] The Commissioner may reconsider and revoke an allowance for refund at any time before the allowance is paid, but whether a commissioner has power to revoke an allowance made by his predecessor is not clear.[25] Where one Commissioner recommended the allowance of the claim and referred the matter to the Secretary for advisement, a succeeding Commissioner to whom the matter was referred back could reject the claim.[26] The Commissioner is not precluded from allowing a claim for refund because a former Commissioner rejected a claim for abatement, and he is authorized to reconsider and allow a claim which he had, through error of law, previously rejected. An application for the refund of taxes, though informal or defective, may be regarded as a claim, so far at least as to permit a formal amendment to be filed after the statute of limitations has run.[27] No equity powers are conferred on the Commissioner, and the Commissioner is authorized, not obliged, to refund.[28]

STATUTE OF LIMITATIONS. Except as stated in the next paragraph all claims for refund must be presented to the Commissioner within two years next after the cause of action accrued,[29] that is after the tax was paid. Failure to make a claim for refund within two years after paying the tax is a bar to a suit thereon.[30] Presentation to the collector is equivalent to presentation to the Commissioner.[31] Where a protest was held by the Commissioner to be an informal appeal, and a formal application for refund was thereafter acted upon, although made after the expiration of two years, his decision has been held to be conclusive and could not be set aside by the court.[32] As to taxes assessed under the Revenue Act of 1918, no claim for refund will lie after the expiration of five years from the time the return was due.[32a]

[24] Dugan v. U. S., 34 Ct. Cls. 458; Cumming v. U. S., 22 Ct. Cls. 344.

[25] Ridgway v. U. S., 18 Ct. Cls. 707.

[26] Stotesbury v. U. S., 23 Ct. Cls. 285.

[27] 14 Op. Atty. Gen. 615.

[28] 16 Op. Atty. Gen. 667; 13 Op. Atty. Gen. 439.

[29] R. S., § 3228.

[30] Kings County Savings Institution v. Blair, 116 U. S. 200.

[31] Real Estate Savings Bank v. U. S., 16 Ct. Cls. 335; 104 U. S. 728.

[32] Bank of Greencastle v. U. S., 15 Ct. Cls. 225.

[32a] Revenue Act of 1918, § 252; Letter from Treasury Department dated October 9, 1919; I. T. S. 1919, ¶ 3652.

When Statute of Limitations Is Extended. Although generally the provisions referred to in the previous paragraph [33] limit all claims for refund to a period of two years after the tax has been paid, an extension of this time is granted in cases where, upon examination of any return of income made pursuant to the Revenue Act of 1918, the Revenue Act of 1917, the 1916 Law, the 1913 Law or the 1909 Law, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due. In such case, notwithstanding the provision of law referred to in the preceding paragraph [34] the amount of excess is credited against any income, war-profits or excess-profits taxes or installment thereof then due under any other return and any balance of such excess is immediately refunded to the taxpayer, provided that no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.[35] This provision was inserted as a remedy in cases where an agent of the Treasury Department makes an examination of a taxpayer's books within five years [36] after a return has been filed and discovers undisclosed income. An examination may also disclose an overpayment, as well as undisclosed income, in which case the result of the examination may operate to the benefit of the taxpayer as well as to the benefit of the Government, regardless of the statute of limitations. Claims once rejected by the Commissioner, because of the statute of limitations, in existence at that time, may be reopened under this provision, if the adjustment necessitates an examination of the return, but not otherwise.[37]

Procedure for Claiming Refund. The provisions for claiming refund must be strictly complied with.[38] Claim for the refunding of assessed taxes and penalties must be made out upon

[33] R. S., § 3228.

[34] R. S., § 3228.

[35] Revenue Act of 1918, § 252. Under the 1916 Law the taxpayer was merely permitted to present a claim for refund, such a claim not being ordinarily necessary under the present law. See Revenue Act of 1916, § 14.

[36] This limitation was three years under the 1916 Law. Revenue Act of 1916, § 14 (a).

[37] T. D. 2396.

[38] Public Service Ry. Co. v. Herold, 219 Fed. 301; Public Service Gas Co. v. Herold, 227 Fed. 496, 229 Fed. 902.

the form prescribed by the Government. The burden of proof rests upon the claimant. All the facts relied upon in support of the claim must be clearly set forth, under oath.[39] The practice is to obtain a copy of the form from the local collector, prepare it according to instructions thereon, and file it with the local collector for further action.[40] The collectors of internal revenue and revenue officers are forbidden to prepare affidavits for persons claiming remission of taxes or penalties under the internal revenue law.[41] An appeal for abatement or refund is imperfect if it does not have endorsed thereon the affidavit of the deputy collector and certificate of the collector required by the regulations,[42] but this is a matter of action within the Department. A claim should be accompanied by the collector's receipt or the cancelled check showing payment of the tax. The affidavit may be made by an agent of the person assessed, but in such a case a power of attorney must accompany the claim. Warrants in payment of claims allowed will be drawn in the names of the persons entitled to the money and will, unless otherwise directed, be sent by the Treasurer of the United States directly to the proper persons or their duly authorized attorneys or agents. In certain cases of overpayment by taxpayers the collector may repay the excess after allowance by the Commissioner of a claim for refund, made by the collector on Form 751. The cases in which refund is made through collectors are covered by specific provisions and discussed elsewhere.[43] The Commissioner has no authority to refund on equitable ground penalties legally collected.[44]

PROCEDURE BY COLLECTORS. The Treasury Department has prescribed the following procedure to be followed by collectors on the receipt of claims for refund or abatement: Claims for refund

39 Reg. 45, Art. 1032; Reg. 14 Rev. The form to be used in claiming refund is officially known as form 46.

40 Claims for refund may be forwarded direct to the Commissioner of Internal Revenue, Claims Division, Income Tax. (See letter from Treasury Department dated March 29, 1919; I. T. S. 1919, Par. 3309.)

41 T. D. 2443.

42 Hastings v. Herold, 184 Fed. 759.

43 See p. 570.

44 Reg. 45, Art. 1036; T. D. 2871. In the case of a taxpayer's death, certified copies of the letters of administration or letters testamentary, or other similar evidence, should be annexed to the claim to show the authority of the administrator or executor.

or for abatement, pertaining to tax returns which have not at the time been posted to an assessment list, will be numbered to agree with, attached to, and made a part of, the original return so that the total tax as posted on the assessment list will be the admitted tax liability of the taxpayer. If a taxpayer submits an amended return as a claim either for refund or for abatement before the original return has been listed, such amended return will be numbered to agree with and attached to the original return in the same manner. Similarly, errors or omissions in returns discovered by the collector prior to the posting operate as an amendment to the amount of tax liability shown by the return. In other words, all amendments or changes either increasing or decreasing the amount of tax liability and whether originated by the taxpayer or by the collector will be reflected on the face of the return itself and the posting to the assessment list will be of the correct amount. Amended returns showing a reduced tax liability will not be acted upon by collectors if the original return has been previously entered on the assessment list. All claims pertaining to returns which have been listed for assessment must be submitted on Form 46, if the tax has been paid, or on Form 47, if the tax has not been paid. The following classes of claims may be included on Form 751 (if for refund), or blanket Form 47 (if for abatement). Separate sheets properly designated of Forms 751 or blanket Forms 47 must be prepared for returns on file in the Commissioner's office and those on file in the collector's office: (a) All claims for refund or abatement pertaining to Form 1040-A income returns for the calendar year 1918, or subsequent years. (b) Errors in computation. (These include only mistakes in arithmetic.) (c) Errors in *specific* exemptions on income returns. (These include such items as failure to deduct exemptions for dependents; the $2,000 exemption for corporations, etc.) (d) Payments in excess of the total amount of tax due as shown by the return. (These include such cases as a remittance of $1,500 covering payment of a tax liability of $1,300, etc.) (e) Amount previously paid on submission of a tentative income return in excess of the total tax liability shown by the final return. (f) Duplicate payments or assessments. (g) All claims for refund on account of nonrevenue remittances forwarded to the collector in error and deposited by him. (These include such items as state or municipal taxes sent to the collector and deposited by him as

"unidentified," etc.) All claims for refund or abatement other than those enumerated above will be forwarded to the Commissioner for settlement. However, *any* claim may be so forwarded whenever the collector does not feel absolutely certain of the law, regulations or precedent involved, or if his disbursing bond is insufficient to enable him to procure an advance on accountable warrant of the requisite amount of funds from which to make payment. Before forwarding claims to the Commissioner for settlement certification must be made on the claim of the account number, the amount of tax originally due, the dates and amounts of all payments or other transactions affecting such amount, and the balance due as shown by the account on the list. All claims of this nature now on file in the collector's office and hereafter as received should be certified and forwarded immediately. Claims submitted by taxpayers direct to the Commissioner will in future be referred to the collector for this certificate as to the status of the account on the assessment list. Until so certified by the collector such claims will not be settled.[45]

Suits to Recover Taxes. If a claim is rejected by the Commissioner, a judicial remedy is given the taxpayer by an action against the collector or the United States. If the claim is allowed by the Commissioner and payment refused by the accounting officers, a suit may be brought directly against the Government in the Court of Claims.[46] The allowance of the claim by the Commissioner may be used as the basis of an action against the United States in the Court of Claims, when payment is not made by reason of the refusal of any of the officers of the Department to pass or to pay the claim, and it will be *prima facie* evidence of the amount that is due, and puts on the Government the burden of showing fraud or mistake.[47] Before a suit can be commenced to recover taxes erroneously or illegally assessed or collected, or upon any penalty claimed to have been collected without authority, or for any sum alleged to have been excessive or in any manner wrongfully collected, an appeal must be made to and a decision rendered by the Commissioner, according to the provisions of law in that regard, and the regulations of the Secretary es-

45 T. D. 2871.

46 Edison Electric Co. v. U. S. 38 Ct. Cls. 208.

47 U. S. v. Real Estate Savings Bank, 104 U. S. 728; Kaufman v. U. S., 96 U. S. 567; Christie-Street Commission Co. v. U. S., 136 Fed. 326.

tablished in pursuance thereof. If such decision is delayed more than six months from the date of appeal, suit may be brought, without first having a decision of the Commissioner,[48] but need not be commenced until within two years after the Commissioner has denied the claim.[49] No suit to recover taxes alleged to have been erroneously or illegally assessed or collected may be maintained in any court, unless it is brought within two years next after the cause of action accrued.[50] The accrual of the cause of action for purposes of a suit against the government or a collector is the date when the Commissioner decides adversely to the taxpayer; that is, the claimant may await the decision of the Commissioner, and if it is adverse, may bring suit within two years thereafter. But he is not required to await such adverse decision; he may at his election bring suit at any time after the expiration of six months from the filing of his claim for refund, if no decision has been rendered by the Commissioner.[51] For example, if a tax is paid on June 28, 1919, the claim for refund must be filed on or before June 28, 1921.[52] If the claim is filed on June 28, 1921, the taxpayer may commence his action on December 29, 1921, if no decision has been rendered by the Commissioner. If, however, an adverse decision is rendered by the Commissioner on September 21, 1921, the taxpayer may at once institute action but has until September 21, 1923, in which to do so. The rejection of a claim by the Commissioner, must be on the merits and not for irregularity in the form in order to support an action.[53] If an imperfect claim is filed within two years, it seems to be within the statute, although the corrected application is not made within

48 R. S., § 3226.

49 R. S., §§ 3226 and 3227.

50 R. S., § 3227.

51 New York Mail and Transportation Co. v. Anderson, 234 Fed. 590; State Line & S. R. Co. v. Davis, 228 Fed. 246; Merck v. Treat, 174 Fed. 388; Farrell v. U. S., 167 Fed. 639; Christie Street Commission Co. v. U. S., 136 Fed. 326; Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272; Cheatham v. U. S., 92 U. S. 85; Kings Co. Inst. v. Blair, 116 U. S. 200. It has been held that the cause of action for purposes of an action against the collector accrued six months after claimant had filed a claim for refund and that the claimant had two years *from that date* within which to bring suit. (Schwarzchild & Sulzberger Co. v. Rucker, 143 Fed. 656.) This seems to be the view of the Treasury Department. See Reg. 45, Art. 1037.

52 New York Mail and Transportation Co. v. Anderson, 234 Fed. 590.

53 Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272.

that time, and if suit is brought within two years after rejection of the corrected claim, it is within the statute, although more than two years have expired since the first rejection. If the application for refund was filed more than two years after paying the tax, suit cannot be maintained, and the fact that the Commissioner rendered an adverse decision on the application, when filed, does not operate to extend the time.[54]

SUIT AGAINST COLLECTORS. The collector who exacted the tax may be sued for the recovery thereof, but an action thereon cannot be commenced against his successor in office. The remedy lies in an action against the collector to whom the tax was paid, or in an action against the United States.[55] It has been held that an action of *assumpsit* may be maintained against the collector who actually exacted the tax, and such action can be revived against the personal representative of the deceased collector.[56] When once an action has been lawfully commenced against a collector, it does not abate by reason of the expiration of his term, but in such event the court may, under the express provisions of a statute,[57] allow the suit to be maintained against his successor. Suits against collectors are brought on the theory of money had and received and in such suits the plaintiff may recover only such money as he is in equity entitled to, and as defendant is not entitled to retain.[58]

SUITS AGAINST THE UNITED STATES. Suit for recovery of taxes alleged to have been wrongfully assessed and collected may be maintained directly against the United States under the so-called Tucker Act.[59] In answer to the question, "Can the plaintiff bring suit to recover taxes, alleged to have been wrongfully assessed and collected under the corporation tax law, directly against the United States under the Tucker Act, other requirements of law

54 P. S. Ry. Co. v. Herold, 219 Fed. 301.

55 Philadelphia H. and P. R. Co. v. Lederer, 242 Fed. 492; Roberts v. Lowe, 236 Fed. 604. In the latter case the court said the latter remedy was apparently authorized by the case of U. S. v. Emery, 237 U. S. 28. As to suing a collector personally under a state law for damages in wrongfully collecting taxes, see P. S. Ry. Co. v. Herold, 229 Fed. 902, 910.

56 Patton v. Brady, Executrix, 184 U. S. 608.

57 Act of February 8, 1899; 30 Stat. L. 822, c. 121.

58 N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576.

59 Judicial Code § 24, ¶ 20; Ch. 397, 24 Stat. 635 (U. S. Compiled Stats. p. 3635).

having been complied with, or is its remedy against the Collector of Internal Revenue by whom the assessment and collection were made" it was held that the question was no longer open.[60] The Tucker Act refers to original suits, and does not permit a recovery of demands against the United States on counterclaims.[61]

PROTEST AND DURESS. In order to maintain an action for the recovery of taxes it is necessary that the tax shall have been paid under protest and duress.[62]

CLAIMS FOR REFUND OF SUMS RECOVERED BY SUIT. Claims by taxpayers for the amount of a judgment representing taxes or penalties erroneously collected should be made on form 46. The claimant should state the grounds of his claim under oath, giving the names of all the parties to the suit, the cause of action, the date of its commencement, the date of the judgment, the court in which it was recovered, and its amount. To this affidavit there should be annexed a certified copy of the final judgment, a certificate of probable cause, and an itemized bill of the costs paid receipted by the clerk or other proper officer of the court, together with a certified copy of the docket entries of the court in the case, or so much thereof as may be required by the Commissioner. When a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution will issue against such collector or other officer, but the amount so recovered will, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury. If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name. There should also be a certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction,

60 Emery, Bird Thayer Realty Co. v. U. S., 198 Fed. 242, citing Christie-Street Commission Co. v. U. S., 136 Fed. 326.

61 U. S. v. Nipissing Mines Co., 206 Fed. 431.

62 For a discussion of this subject see Chapter 35.

with a detail of all items of costs which were paid by the judgment debtor or for which he is liable.[63]

Recovery of Interest. It is a well-settled principle that the United States is not liable to pay interest on claims against it, in the absence of express statutory provision to that effect. It has been established as a general rule in the practice of the Government that interest is not allowed on claims against it, whether such claims originate in contract or in tort; whether they arise in the ordinary business of administration, or the private acts of relief by Congress on special application. The only recognized exceptions are where the Government stipulates to pay interest, and where interest is given expressly by an Act of Congress, either by the name of interest, or damages. Not only is this the general principle and settled rule of the executive department of the Government, but it has been the rule of the legislative department, because Congress, though well knowing the rule observed at the Treasury, and frequently invited to change it, has refused to pass any general law for the allowance and payment of interest on claims against the Government.[64] Where a person accepts from the Government without objection a refund of a sum illegally exacted he gives up his right to sue for interest.[65] The ground for refusal to allow interest is the presumption that the Government is always ready and willing to pay its ordinary debts. When, however, an illegal tax has been collected, the citizen who has paid it, and has been obliged to bring suit *against the collector,* is entitled to interest in the event of recovery, from the date of the illegal exaction.[66] In a case where there had been a delay of thirty years in prosecuting a claim to recover internal revenue taxes, interest was not allowed from the date of payment of the taxes, but was allowed from the time of commencing the suit.[67] It has been held that where railroads, seeking to recover internal revenue taxes illegally assessed, delayed in pressing their claims on account of an understanding with the collectors that the claims should await the decision of other pending cases, but it

63 Reg. 45, Arts. 1031 and 1038.

64 U. S. v. Bayard, 127 U. S. 251.

65 Stewart v. Barnes, 153 U. S. 456.

66 Erskine v. Van Arsdale, 15 Wall. 75; Old Colony R. Co. v. Gill, 257 Fed. 220; Redfield v. Bartels, 139 U. S. 694.

67 Burrough v. Abel, 105 Fed. 366.

became apparent that the question of interest could not be adjusted, the railroad's conduct did not disentitle them to interest for any lack of diligence in prosecution.[68] It seems clear that in a suit against a collector interest may be recovered whether or not the same rule applies to suits against the United States.[69] On recovery of a judgment against a collector for the amount of an internal revenue tax illegally collected, the plaintiff is entitled to have the judgment state that it is with interest.[70] Where judgment is recovered in an action against a collector, interest may be recovered up to the time final judgment is entered and a certificate from the trial court that there was probable cause for the collection of the tax has been given. Upon giving such certificate the claim becomes one against the United States, stopping the right to further interest, unless a review of the judgment by an appellate court is obtained, in which event the judgment upon the mandate of the appellate court will be treated as a final judgment, to the rendition of which interest will be allowed, unless the plaintiff unduly delays the presentation of his claim.[71] A suit against a collector is a private suit and there is no claim against the Government until a certificate of probable cause, under the Revised Statutes,[72] has been obtained from the court, at which time the Government assumes a definite liability of the collector, which does not include the payment of interest thereafter; neither is there any further personal liability on the part of the collector. The interest which may be recovered is that put into the judgment before there is any certificate of probable cause, and if none has been put in, the Government assumes no part of the liability of the defendant. The liability assumed by the Government includes interest and costs forming part of the recovery, but does not include interest after judgment.[73]

Costs. The Revised Statutes[74] authorize the Commissioner to repay to any collector or deputy collector the full amount of such

68 Boston & P. R. Corp. v. Gill, 257 Fed. 221.

69 Conant v. Kinney, 162 Fed. 581.

70 New York Mail and Newspaper Transportation Co. v. Anderson, 234 Fed. 590.

71 Klock Produce Co. v. Hartson, 212 Fed. 758.

72 R. S., § 989.

73 White v. Arthur, 10 Fed. 80.

74 R. S., § 3220, as amended by the Revenue Act of 1918. The amendment extends the provision to assessors, assistant assessors and agents.

sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent or inspector in any suit brought against him by reason of anything done in the due performance of his official duty. Under this section costs may be recovered against the collector.[75] Judgment is usually given in the District Court for costs and interest.

Claims for Abatement of Uncollectible Taxes. When a tax is found to be uncollectible, the collector or deputy collector who made the demand for payment and is conversant with the facts may prepare a claim for abatement on form 53. Although credits allowed on account of insolvency or absconding release the collector from the obligation created by his receipt for the amount credited, the obligation to pay still remains upon the person assessed. It is the duty of the collector to use the same diligence to collect a tax after it has been abated as uncollectible as before abatement. Collectors should therefore keep a record of all taxes thus credited and of the persons from whom they are due, and should enforce payment whenever it is in their power to do so.[76]

[75] De Bary v. Carter, 102 Fed. 130. However, see Treat v. Farmers Loan and Trust Co., 185 Fed. 760, 763, as to costs in the Supreme Court and Circuit Court of Appeals.

[76] Reg. 45, Art. 1033.

CHAPTER 38

EXAMINATION OF TAXPAYERS' BOOKS

The Revenue Act of 1918 and the Revised Statutes contain certain provisions for the examination of taxpayers' books by revenue agents or inspectors, the attendance of witnesses before the Commissioner and the production of books in suits or proceedings arising under the revenue laws which are set forth in the following paragraphs.

Examination of Books. For the purpose of ascertaining the correctness of any return or making a return where none has been made, the Commissioner may, by any revenue agent or inspector designated by him for that purpose, examine any books, papers, records or memoranda bearing upon the matters required to be included in the return.[1]

Requiring Attendance of Witnesses. For the purpose stated in the previous paragraph the Commissioner may require the attendance of the person rendering a return or of any officer or employee of such person *or the attendance of any other person having knowledge in the premises*[2] and may take his testimony with reference to the matters required to be included in such return. The Commissioner, every collector, deputy collector, internal revenue agent, and internal revenue officer assigned to

1 Revenue Act of 1918, § 1305. In relation to the income tax this provision seems to supplant R. S., § 3173, which as amended, omits the second case "in case of income tax on or before the first day of March in each year, or on or before the last day of the sixty day period next following the closing date of the fiscal year for which it makes a return of its income" and also omits the phrase "amount of annual income charged with a duty or tax."

2 The italicized words would seem to have been inserted to avoid the effect of such decisions as In re Chadwick, 5 Fed. Cas. No. 2,570, 11 Int. Rev. Rec. 126, 133, which held under a similar statute that the books which the assessor has the right to examine are those of the person whose assessment is in question and not those of third persons who have had dealings with him, and consequently that a corporation was not bound to produce its books upon an inquiry into the income of its shareholders.

duty under an internal revenue agent is clothed with power to administer oaths to such person or persons as may be required to attend any hearing before him.[3]

Requiring Production of Books. In all suits and proceedings, other than criminal,[4] arising under any of the revenue laws of the United States, the attorney representing the Government may, whenever in his belief any business-book, invoice or paper, belonging to or under the control of the defendant or claimant, will tend to prove any allegation made by the United States, make a written motion particularly describing such book, invoice or paper, and setting forth the allegation which he expects to prove; and thereupon the court may, at its discretion, issue a notice to the defendant or claimant to produce the same. Upon failure to do so the allegation stated in the motion is taken as confessed, unless the failure or refusal is explained to the satisfaction of the court.[5] This provision applies to proceedings under the internal revenue laws as well as the customs revenue laws.[6]

Enforcement of Provisions Requiring Examination, Attendance and Production. If any person is summoned to appear, to testify, or to produce books, papers or other data, the United States District Court for the district in which such person resides is invested with jurisdiction of appropriate means to compel such attendance, testimony, or production of books, papers or other data, and to make and issue, both in actions at law and suits in equity, such writs, orders, judgments, decrees and process as may be necessary or appropriate for the enforcement of any provisions requiring such attendance, testimony or production, but only at the instance of the United States. Any remedy of application to the District Court is in addition to and not exclusive of any and all remedies of the United States in such courts and otherwise to enforce such provisions.[7]

3 Revenue Act of 1918, § 1305; R. S., § 3165, as amended.

4 In Boyd v. U. S., 116 U. S. 616, it was held that proceedings to forfeit a person's goods for an offense against the law, though civil in form, and whether *in rem* or *in personam*, was a "criminal" case, within the meaning of this provision of law.

5 Act of June 22, 1874, 18 Stat. 187.

6 U. S. v. Distillery No. 28, 25 Fed. Cas. No. 14,966.

7 Revenue Act of 1918, § 1318.

Constitutionality of Statute Providing for Examination and Production of Books. It has been held that (1) the above mentioned provision of law requiring the production of books is unconstitutional and void as to suits for penalties or to establish a forfeiture, because repugnant to the Fourth and Fifth amendments to the Constitution, which are to be construed in relation to each other; (2) actual entry upon premises and search for and seizure of papers is not required to bring a case within the meaning of the Fourth amendment prohibiting unreasonable searches and seizures; (3) a compulsory production of a party's private books and papers to be used against him or his property in a criminal or penal proceeding or proceeding for a forfeiture is within the spirit of such amendment; (4) it is equivalent to compulsory production to make non-production a confession of the allegations which it is pretended such books will prove; (5) a proceeding to forfeit goods, though civil in form and whether *in rem* or *in personam*, is a criminal case within the meaning of the Fifth Amendment which declares that no man "shall be compelled in any criminal case to be a witness against himself": and (6) the seizure or compulsory production of a man's private papers to be used against him is equivalent to compelling him to be a witness against himself.[8] It is doubtful, however, whether this decision and others of a similar purport[9] relate to proceedings to assess and recover unpaid taxes, or to discover the extent of a person's tax liability, to accomplish which ends the compulsory production of books and papers may be considered a legitimate and appropriate means within the legislative discretion. The constitutionality of a similar statute for the enforcement of the internal revenue laws has been upheld,[10] and

8 Boyd v. U. S., 116 U. S. 616.

9 Weeks v. U. S., 232 U. S. 383; In re Pacific Railway Comm., 32 Fed. 241.

10 In re Strouse, 23 Fed. Cas. No. 13548; 1 Sawy. 605; 11 Int. Rev. Rec. 182. In re Platt, 19 Fed. Cas. No. 11,212, a distinction is pointed out between the constitutionality of an act and the constitutionality of the manner in which the act is administered in any particular case, as follows: "A search and seizure may be unreasonably conducted, in execution, under the statute authorizing it, and thus the right of security sought to be protected by the fourth amendment may be violated; and, under what is due process of law, as authorized by the statute, a person may be deprived of his property, when the statute did not contemplate or authorize such deprivation, and thus the fifth amendment may be violated. But these things are not the fault of the statute

it has been asserted that acts conferring the high power upon administrative officers of compelling the production of books and attendance of persons have been acquiesced in for so long a time without serious objection that their constitutionality is no longer open to debate.[11] Upon a *habeas corpus* proceeding in the case of a tobacco manufacturer who was committed for failure to appear and produce books in obedience to a summons, it was held that (1) he must bring the books containing the entries relating to his business before the assessor; and (2) he might then be asked to exhibit any entry relating to a particular point and if he should say he could not do so without incriminating himself, he would be protected from exhibiting it.[12] In a later case[13] in the Supreme Court, which sustained the validity of the Interstate Commerce Act so far as it gave power to the Commission to require the attendance of witnesses and the production of papers, it was held that it was open to each witness to contend that he was protected by the Constitution from answering the questions propounded to him, that he was not legally bound to produce the books or papers, and that neither the questions propounded nor the books called for related to the matter under investigation. This authority by analogy would seem to dispose of the argument that information brought out in a proceeding under the internal revenue laws to ascertain the amount of tax liability of any taxpayer might be used against him in a later criminal proceeding or proceeding for a penalty or forfeiture.

as it stands. They grow out of the fact that the statute is administered, in the particular case, in a manner not authorized by the statute. They are violative alike of the statute and of the constitution, but they have no effect to make the statute unconstitutional.''

11 Perry v. Newsome, 19 Fed. Cas. No. 11,009; 10 Int. Rev. Rec. 20.

12 In re Lippman, 3 Ben. 95; 15 Fed. Cas. No. 8,382; 9 Int. Rev. Rec. 1. This case arose under section 14 of the act of June 30, 1864.

13 Interstate Commerce Commission v. Brimson, 154 U. S. 447; 155 U. S. 3. This argument is disposed of in another manner in Re Phillips, 19 Fed. Cas. No. 11097; 10 Int. Rev. Rec. 107. The court makes the following quotation from Peo. v. Hackley, 24 N. Y. 83: ''But neither the law nor the constitution is so sedulous to screen the guilty as the argument supposes. If a man cannot give evidence upon the trial of another person without disclosing circumstances which will make his own guilt apparent, or at least capable of proof, though his account of the transaction should never be used as evidence, it is the misfortune of his condition and not any want of humanity in the law.''

While a witness being examined *de bene esse* under section 863 of the Revised Statutes may be compelled to produce books and papers which would be material evidence for the party calling him upon the trial of the case, he may not be compelled to produce his books and papers merely for the purpose of refreshing his memory.[14] The cases upon this point are in some confusion and the distinction between criminal or quasi-criminal proceedings involving penalties and forfeitures and proceedings to ascertain and recover the amount of any tax due, is nowhere clearly drawn.

Corporations. It will be noted that in so far as the above mentioned provisions relating to the examination of witnesses and the production of books and papers have been or may still be declared void, their unconstitutionality is based upon a violation of the Fourth and Fifth amendments to the Constitution of the United States. It is by no means definitely settled to what extent corporations, which are creatures of the state, are protected and given immunity by virtue of such amendments. In a comparatively recent case in the Supreme Court[15] it was held that corporations were not protected by the Fifth amendment and that while an individual may lawfully refuse to answer incriminating

14 U. S. v. Tilden, 28 Fed. Cas. No. 16,522; 10 Ben. 566; 25 Int. Rev. Rec. 352.

15 Hale v. Henkel, 201 U. S. 43; Nelson v. U. S., 201 U. S. 92. The court was considerably divided in this case. The opinion of the majority was delivered by Mr. Justice Brown. Mr. Justice Harlan delivered a separate concurring opinion in which he went further than the majority and stated his opinion that a corporation could not claim immunity under the Fourth amendment for the reason that it is not a part of the "people" or embraced by the word "persons" as used in that amendment. Mr. Justice McKenna, also concurring, stated his opinion that corporations had no immunity under the Fourth amendment, because as stated in Boyd v. U. S., 116 U. S. 616, the Fourth and Fifth amendments were complimentary of each other and the denial of the protection of one carried a denial of the protection of the other. Mr. Justice Brewer, with whom the Chief Justice concurred, dissented, and stated their opinion that the immunities and protection of the Fourth and Fifth amendments are available to corporations so far as in the nature of things they are applicable. In International Mining Co. v. Pennsylvania Railroad Co., 152 Fed. 557, Judge Holland, in holding that a corporation may not refuse to produce its books in an action against it to recover damages or penalties for a violation of the Interstate Commerce Commission act, expresses the opinion that the question had been practically disposed of by the Henkel case.

questions unless protected by an immunity statute, it does not follow that a corporation vested with special privileges and franchises may refuse to produce its books and papers, but the court expressly stated that it did not wish to be understood as holding that a corporation is not entitled to immunity under the Fourth amendment against unreasonable searches and seizures.

National Banks. The law under which national banks are incorporated, which provides for the occasional examination of their affairs and reports of their condition to the national government and enacts that they shall not be subject to any visitorial powers other than are authorized by the act or are vested in the courts of justice, does not exempt them from liability to examination.[16]

Examination of Books and Papers in the Cases of Special Taxes and Other Cases. In the case of any special tax and in the case of other[17] taxes it is the duty of any person, partnership, firm, association or corporation liable to make a verified return to the collector where the articles or objects or goods, wares or merchandise charged with the tax are located. In case of failure to make such return, if the person liable consents to disclose the particulars, it is the duty of the collector or deputy collector to make the list or return which, when consented to, is received as the return of such person. If any person, on being notified or required to make this return by the leaving at his place of residence or business with someone of suitable age or discretion or the depositing in the nearest post office a memorandum addressed to him, refuses or neglects to make the return within ten days from the date of the notice, or delivers any return, which in the opinion of the collector is erroneous, false or fraudulent or contains any under-valuation or under-statement, or refuses to allow a regularly authorized government officer to examine his or its books, the collector may summon such person, partnership, firm, association or corporation or any person having possession, custody or care of the books of account containing entries relating to the business of such person, partnership, firm, association or corporation, or any other person, to appear before him and produce the books and give testimony

16 U. S. v. Rhawn, 27 Fed. Cas. No. 16,150.

17 See note 1.

or answer interrogatories respecting any objects liable to tax or the returns thereof. When the person intended to be summoned does not reside in the State or territory in which the collector's district lies, the collector may enter any collection district where the person may be found and there make the above examination.[18]

Inspection of Government Contracts. Every person who on or after April 6, 1917, entered into any contract, undertaking, or agreement with the United States or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States, is required within thirty days after a request of the Commissioner therefor, to file with the Commissioner a true and correct copy of every such contract, undertaking, or agreement. Failure to comply with such requests of the Commissioner is punishable as a misdemeanor and by a fine of not more than $1,000, or by imprisonment for not more than one year, or both. The Commissioner (when not violative of the technical military or naval secrets of the Government) has access to all information and data relating to any such contract, undertaking or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States and may call upon any such department, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.[19]

Instructions to Revenue Agents. The followings instructions have been given by the Treasury Department to revenue agents and examiners: "In conducting their examination the agents will, except in clear cases of misrepresentation, proceed on the assumption that all errors in the returns rendered are unintentional; and they will, so far as possible, make their examination in such manner as not to interfere with the company's business.

18 R. S., § 3173 as amended. See Reg. 33, Art. 186.
19 Revenue Act of 1918, § 1408.

either as to the use of its books or in the general conduct of its affairs. Contentions with officers, employees or representatives of corporations are to be carefully avoided, and no action that may cause friction, that is not necessary in the proper performance of their duties, must be indulged in by officers making these examinations. Ordinarily no very extended examination of the company's books will be necessary, as the verification of the particular items to which attention has been called will be sufficient. Where, however, a thorough examination is found to be necessary, and the accounts are so kept as to involve much labor in their examination, the agent may assign two assistants for this purpose. Where discrepancies between the company's books and the return made are discovered, the officers of the company should be given full opportunity to explain the same, and to furnish, if so desired, a sworn statement in reference thereto In such cases the agent will, if deemed necessary, require the attendance of any officer or employee of the company, and there examine such officer or employee respecting the matter under investigation. The witnesses in such cases should be duly sworn by the agent, and in case of refusal of any such officer or employee to testify, or in the case of refusal to produce the books or papers called for, the agent will at once report the fact to this office." [20]

[20] T. D. 1617.

CHAPTER 39

INFORMATION AT THE SOURCE

To assist in the administration of the income tax law, certain information is required to be furnished by brokers as to their customers, by corporations as to dividend and interest payments, by first or last banks or collection agencies as to foreign items. and by individuals, partnerships and corporations generally (including lessees or mortgagors of real or personal property, fiduciaries, and employers) as to payments of income to others, in order that the Treasury Department may have data on which to audit returns of income.[1] The several classes of payments which are required to be reported, and the provisions with respect to each, are discussed in the following paragraphs.

Miscellaneous Income, Gains and Profits. It is provided that payments of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits and income of $1,000 or more must be reported by the payor thereof.[2] "Fixed or determinable gains, profits and income," as used in the law,[3] would seem to include payments of all the kinds expressly enumerated and all payments of a similar nature. In the case of collection at the source payments must be annual or periodical, while in the case of information at the source the law does not contain such a limitation. Hence any payments of the kind described in the law, whether made in isolated cases, or from time to time, must be reported.[4] If the aggregate of several payments made to the same payee equals or exceeds $1,000 in any taxable year, the

[1] Revenue Act of 1918, §§ 254, 255, and 256. These administrative provisions first appeared in the 1916 Law by amendment in 1917.

[2] Revenue Act of 1918, § 256. There must be payment. Interest accrued on bank deposits before it has passed to the credit of the depositor need not be reported. (T. D. 2670.)

[3] Revenue Act of 1918, § 256.

[4] Reg. 45, Art. 1071. Payments made to corporations, associations, and insurance companies for the year 1917 did not require reporting.

gross amount should be reported. The payments may be from different forms of income, as for instance, from interest and rent, or interest and salary. In such cases, it seems the total is required by law to be reported, if the aggregate of all payments in the year to the same payee equals or exceeds $1,000.

SALARIES, WAGES OR COMPENSATION. The names of all employees to whom payments exceeding $1,000 a year are made, whether such total sum is made up of wages, salaries, commissions or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In the case of an employer having a large number of employees who are moved from place to place as the exigencies of the service require, and who consequently has no complete record of annual payments to them at any one place, the salary of two representative months may be taken to establish a fair monthly wage, and unless the yearly payment based on this estimate in the case of an employee amounts to $1,000 or more, no return of payments to such employee is required.[5] When living quarters such as camps are furnished for the convenience of the employer, the ratable cost need not be added to the cash compensation of the employee in determining whether it equals $1,000 annually. But where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax, and a return of information is required in such case where the cash compensation received plus the value of living quarters furnished equals $1,000 for the year.[6] Bills paid to employees for board and lodging while traveling under orders or when the employee is employed on a salary basis, are not part of the employee's salary.[7] Commissions paid to soliciting agents for personal services in securing insurance contracts must be reported at the source, but if the agent conducts a branch office or is em-

[5] Reg. 45, Art. 1072.

[6] T. D. 2670; Reg. 33 Rev., Art. 34; Letter from Treasury Department, dated October 25, 1917; I. T. S., 1919, ¶ 1345. See Reg. 45, Art. 33.

[7] T. D. 2670.

ployed by the company under a contract that makes it necessary to bear the expenses of the branch office and all payments received are intended to cover such expenses, they need not be reported.[8]

PAYMENTS WHICH NEED NOT BE REPORTED. Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099 (revised): (a) payments of interest on obligations of the United States; (b) dividends paid by domestic or resident foreign corporations (other than distributions by personal service corporations); (c) payments by a broker to his customers; (d) payments made to corporations: (e) bills paid for merchandise, telegrams, telephone, freight, storage and similar charges; (f) payments to employees for board and lodging while traveling in the course of their employment: (g) annuities representing the return of capital; (h) payments of rent made to real estate agents (but the agent must report payments to the landlord if they amount to $1,000 or more annually); (i) payments made by branches of business houses located in foreign countries to alien employees serving in foreign countries; and (j) payments made by the United States Government to sailors and soldiers and to its civilian employees.[9]

Gains and Losses of Customers of Brokers. When directed by the Commissioner, either specially or by general regulation, every person doing business as a broker is required to render a return showing the names and addresses of customers to whom payments were made or for whom business was transacted during the calendar year or other specified period next preceding and giving the other information called for by the form.[10]

Dividends on Stock of Taxable Corporations. When directed by the Commissioner, either specially or by general regulation, every domestic or resident corporation and every personal service corporation is required to render a return of its payments of

8 Letter from Treasury Department dated March 28, 1918; I. T. S., 1919, ¶ 1341. See also T. D. 2670 and letter from Treasury Department dated March 27, 1918; I. T. S., 1919, ¶ 1347.

9 Reg. 45, Art. 1074.

10 Revenue Act of 1918, § 255; Reg. 45, Art. 1061; Reg. 33 Rev., Art. 33. The new law omits the clause of the old defining brokers, "on any exchange or board of trade or other similar place of business." It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1100 is to be used in making such returns.

dividends, and distributions to stockholders for such period as may be specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated.[11] It will be noted that foreign corporations are subject to this duty if they are resident within the meaning of that term, as discussed in another chapter.[12]

Interest on Obligations of Domestic Corporations. In the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of domestic or resident corporations, the name of the payee is to be reported regardless of the amount of interest paid.[13]

Interest on Obligations of the United States. The law expressly provides that no information at the source is required in the case of payments of interest on obligations of the United States.[14]

State and Municipal Bonds. Although interest received from State and municipal bonds is not subject to tax, the law does not expressly exempt such payments from its requirements as to information at the source; neither does it expressly include such payments. No express ruling has been made as to the procedure to be followed in this respect.

Return of Information as to Payments to Non-Resident Aliens. In the case of payments of annual or periodical income to non-resident alien individuals or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns by withholding agents on forms 1098 (revised) and 1042 (revised) shall constitute and be treated as returns of information.[15]

11 Revenue Act of 1918, § 254; Reg. 45, Art. 1051. This section omits the catch-all phrase in modification of payments of dividends—"Whether made in cash, or its equivalent, or in stock." See, however, the definition of the term "dividend" in Revenue Act of 1918, § 200. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1097 is to be used in making such returns.

12 See Chapter 12. See also Telegram from Treasury Department dated October 14, 1918, I. T. S. 1918, ¶ 3642.

13 Revenue Act of 1918, § 256.

14 Revenue Act of 1918, § 256; Reg. 33 Rev., Art. 37.

15 Reg. 45, Art. 1076.

Foreign Items. The following regulations have been issued under the 1918 Law in regard to foreign items.[16]

SOURCE OF INFORMATION AS TO FOREIGN ITEMS. The term "foreign item," as here used, means any dividend upon the stock of a non-resident foreign corporation or any item of interest upon the bonds of foreign countries or non-resident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank. Wherever a foreign country or non-resident foreign corporation issuing bonds has appointed a paying agent in this country, charged with the duty of paying the interest upon such bonds, such paying agent shall be the source of information. If such foreign country or foreign corporation has no such agent, then the last bank or collecting agent in this country shall be the source of information. In the case of dividends on the stock of a non-resident foreign corporation, however, the first bank or collecting agent accepting such item for collection shall be the source of information.[17]

OWNERSHIP CERTIFICATES FOR FOREIGN ITEMS. (a) Where bonds of foreign countries, or bonds or stocks of non-resident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, or by domestic or resident foreign corporations or partnerships, ownership certificate form 1001 A (revised) shall be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the fiscal agent is required to withhold the normal tax upon the interest on such bonds and ownership certificate form 1000 (revised), modified to show the name and address of the fiscal agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001 A (Revised) should be filed. (b) Where such foreign bonds or stocks are owned by non-resident alien individuals, corporations or partnerships, ownership certificate Form 1001 A

16 See T. D. 2759, amending Reg. 33 Rev., Art. 35, and T. D. 2716 for the rule under the 1916 Law.

17 Reg. 45, Art. 1077.

(revised) shall be used on behalf of such owners by any responsible bank or banker, either foreign or domestic, having knowledge of such ownership. In such a case the bank or banker need not fill in the names of the owners.[18]

RETURN OF INFORMATION AS TO FOREIGN ITEMS. In the case of collections of foreign items, regardless of amount, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. (a) In the case of dividends, as to which the first bank or collecting agent is the source of information, it shall detach the ownership certificate and indorse on the item the words, "Certificate detached and information furnished," adding its name and address. When foreign items have been indorsed as above prescribed, the certificates shall be forwarded to the Commissioner (Sorting Division) on or before the 20th day of the month following that during which the items were accepted, accompanied by a return on form 1096 A showing the number of certificates and the aggregate amount of foreign items disclosed thereon. An annual return on form 1096 B shall be forwarded to the Commissioner not later than March 15 of each year, on which shall be given a summary of the monthly returns. (b) In the case of interest items, as to which the paying agent or the last bank or collecting agent in this country is the source of information, the ownership certificate shall accompany the coupon to such agent or source of information, who shall forward the ownership certificate to the Commissioner in the same manner as above provided with respect to dividend items. Where ownership certificate form 1000 (revised) is used, a monthly return shall be made on form 1012 (revised) and an annual return on form 1013 (revised). Forms 1012 (revised) and 1013 (revised), when so used, should be modified to show the name and address of the paying agent. The use of substitute certificates is not permitted in the collection of foreign items.[19]

LICENSE. The law provides that all individuals, corporations, or partnerships, "undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks or bills of exchange shall obtain a

[18] Reg. 45, Art. 1078. For a full discussion of the subject of ownership certificates, see Chapter 40.

[19] Reg. 45, Art. 1079.

license from the Commissioner, and shall be subject to such regulations enabling the Government to obtain the information required (under this title), as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both."[20] Foreign items should not be accepted for collection by any bank or collecting agent so licensed unless properly indorsed or accompanied by proper ownership certificates giving all the information called for by such certificate.[21] Application for a license for the collection of foreign items should be made to the collector of the district in which the business is to be carried on. Upon the acceptance of such application the collector will issue to the applicant, without cost, a license which will continue in force until revoked or cancelled.[22] Where the collector is not sufficiently informed as to the entire responsibility of the applicant, or where in any case he deems it advisable, the Commissioner may, upon recommendation of the collector, require of the applicant a bond in duplicate with satisfactory sureties in a penal sum at least equal to the estimated amount of tax to be withheld by such applicant during any one year; such bond, however, may not be less than $1,000 nor more than $100,000.[23] This bond, if required, must be renewed annually before January 1 of each year.[24]

Procedure in Paying Income. In order that the payor of the income required by the law to be reported may obtain the necessary information, the law expressly provides, except in the case of reports of dividend payments and reports by brokers, that the name and address of the recipient of income shall be furnished upon demand to the individual, corporation, or partnership paying the income.[25] All payors of income should obtain in some

20 Revenue Act of 1918, § 259.

21 Reg. 45, Art. 1111.

22 T. D. 2759. Application for such license is made on Form No. 1017. A license is issued on Form No. 1010.

23 Reg. 33, Art. 56, January 5, 1914.

24 T. D. 1909.

25 Revenue Act of 1918, § 256.

form the name and address of the recipient of such payments. When the person receiving a payment falling within the provisions of law for information at the source is not the actual owner of the income received, the name and address of the actual owner must be furnished upon demand of the individual, corporation, or partnership paying the income, and in default of a compliance with such demand the payee becomes liable to a penalty of not more than $1,000, unless the failure to comply is wilful, in which event the payee will be guilty of a misdemeanor and will be fined not more than $10,000, or imprisoned for not longer than one year, or both, together with the costs of prosecution.[26] The law imposes no duty, however, upon the payor of the income to inquire upon his own initiative as to the ownership thereof, and it would seem that such payor is fully protected by reporting in good faith the name and address of the one to whom the income is paid.

Returns of Information at the Source. Returns of information at the source must be made as indicated in the following paragraphs.

MISCELLANEOUS INCOME, GAINS AND PROFITS. All persons making payment to another person of fixed or determinable income of $1,000 or more in a taxable year must render a return thereof to the Commissioner (Sorting Division) for the preceding calendar year on or before March 15 of each year. The return shall be made in each case on Form 1099 (revised), accompanied by a letter of transmittal on Form 1096 (Revised) showing the number of returns filed and the aggregate amount represented by the payments. The street and number where the recipient of the payment lives and whether he is single, married or head of a family should be stated, if possible. Where no present address is available, the last known post-office address must be given.[27]

26 Reg. 45, Art. 1080; Reg. 33 Rev., Art. 36. See also Revenue Act of 1918, § 253.

27 Revenue Act of 1918, § 256; Reg. 45, Art. 1071. In the case of payments to non-resident alien individuals or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns by withholding agents on forms 1098 (revised) and 1042 (revised) shall constitute and be treated as returns of information. (Reg. 45, Art. 1076.)

RETURN OF INFORMATION BY PARTNERSHIPS, PERSONAL SERVICE CORPORATIONS AND FIDUCIARIES. Partnerships and personal service corporations shall prepare reports on Form 1099 (Revised) for each member of the partnership or personal service corporation, and fiduciaries shall prepare such reports for each beneficiary of the estate or trust, showing in every case the distributive shares of the members or beneficiaries, whether or not actually distributed. The words "Partnership," "Personal service corporation" or "Fiduciary," as the case may be, should be entered on the blank line of the form under "Kind of income paid." Such reports on form 1099 (revised) are to be filed with the collector with the returns of income of such partnerships, personal service corporations or fiduciaries, instead of being transmitted to the Commissioner accompanied by form 1096 (revised).[28]

GAINS AND LOSSES OF CUSTOMERS OF BROKERS. The law provides that the return to be made by brokers, if required by the Commissioner shall state the names of customers (and impliedly their addresses) for whom such brokers have transacted any business, with such details as to profits, losses, or other information as the Commissioner may require as to each of such customers.[29] It is ruled that the addresses of customers must be stated in such returns.[30]

DIVIDENDS ON STOCK OF TAXABLE CORPORATIONS. With respect to dividend payments of corporations, the law provides that the return to be made by the corporation if required by the Commissioner, shall state the names and addresses of the stockholders, the number of shares owned by each, and the amount of dividends paid to each during the period covered by the report.[31]

28 Reg. 45, Art. 1073.

29 Revenue Act of 1918, § 255; Reg. 45. Art. 1061. Two forms of return are contemplated for the reporting by brokers of the gains and losses of their customers. One form (Form 1100, never issued) shows the total gains and losses of each customer. The other (Form 1096) is merely a letter of transmittal under oath, to be used in forwarding the several forms 1100 to the Commissioner.

30 Reg. 45, Art. 1061.

31 Revenue Act of 1918, § 254. Two forms of return are contemplated for the reporting of dividends paid by taxable corporations. Form 1097 (revised) gives the required information separately with regard to each stockholder, and must, if required, be forwarded to the Commissioner within ten days from the receipt of notice demanding it. Form 1096 (revised) is merely a letter

INTEREST ON OBLIGATIONS OF DOMESTIC OR RESIDENT CORPORATIONS. In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident foreign corporations, the original ownership certificates, when duly filed, constitute and are treated as returns of information. If a bondholder files no ownership certificate in the case of payments of interest on registered bonds, the withholding agent is required to make out such a certificate in each instance and file it.[32]

Exempt Corporations. Exempt corporations are required to furnish information at the source in the same manner and according to the same rules as taxable corporations.[33]

of transmittal under oath, to be used in forwarding the several forms 1097 to the Commissioner. Reporting at the source by corporations may be required specially or by general regulation (Reg. 45, Art. 1051).

[32] Reg. 45, Art. 1075. Monthly return is made on Form No. 1012 (revised). See also Reg. 33 Rev., Art. 43; T. D. 2769.

[33] T. D. 2693.

CHAPTER 40

COLLECTION OF THE TAX AT THE SOURCE

The 1913 Law provided for withholding at the source of the normal tax (1%) on all payments of fixed or determinable annual or periodical income to individuals, whether citizens, residents or non-resident aliens.[1] The 1916 Law provided also for withholding at the source of the normal tax (2%) on payments of similar income to individuals[2] but by the Amendment of October 3, 1917, the law was changed so as to require withholding only (a) on payments of fixed or determinable annual or periodical income (except dividends) to non-resident aliens at the rate of 2%; (b) on payments of interest upon bonds of domestic or other resident corporations to foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, at the rate of 6%; (c) on payments of dividends of domestic or other resident corporations to foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, at the rate of 2%; (d) at the rate of 2% on payment of interest on bonds, mortgages, deeds of trust and similar obligations, of corporations to individuals, citizens, residents or aliens, if such bonds, mortgages, deeds of trust and similar obligations, contained a covenant to pay any portion of the income tax for the bondholder, or to pay the interest without deduction for any tax which the corporation might be required or permitted to pay thereon or to retain therefrom under any law of the United States, and (e) at the rate of 6% where the owner of bonds, mortgages, deeds of trust, or similar obligations, was not known.[3] The amendment was retroactive to January 1, 1917, and any normal tax withheld from income paid to citizens or residents in 1917, other than interest described in (d) above, was

[1] Act of October 3, 1913, § D.
[2] Revenue Act of 1916, § 9 (b), (c), (d), (e).
[3] Revenue Act of 1916, as amended, § 9 (b), (c), (g), 13 (e), (f).

required by the law to be released and paid over to the persons from whose income such tax was withheld.[4]

The 1918 Law provides for withholding at the source on payments of fixed or determinable annual or periodical gains, profits, and income, of any non-resident alien individual (other than income received as dividends from a corporation which is taxable upon its net income) at the rate of 8%, except if the income is from bonds and mortgages, deeds of trust, or similar obligations, of a corporation, containing a covenant to pay any portion of the tax for the bondholder, in which case withholding shall be at the rate of 2%.[5] It is also provided that payments of fixed or determinable annual or periodical gains, profits, and income, of any foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein (other than income received as dividends from a corporation which is taxable upon its net income) shall be withheld at the rate of 10% except in cases where the income is from bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a covenant to pay any portion of the tax for the bondholder, in which case withholding shall be at the rate of 2%.[6] No withholding is required on payment of fixed or determinable income to partnerships whether resident or non-resident, or to citizens or residents, except in case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations, of a corporation containing a covenant to pay the tax, in which case withholding is required at the rate of 2%.[7] In no case is any tax withheld at the source on payments to domestic corporations or to foreign corporations engaged in trade or business within the United States or having an office or place of business in the United States. Personal service corporations may, after receiving notice from the Commissioner that they have been recognized as such, but not before, proceed as though they were partnerships.[7a]

Definition. For convenience, certain terms used in this chapter are here defined. A non-resident foreign corporation is one not

[4] Revenue Act of 1917, § 9 and § 1212.
[5] Revenue Act of 1918, § 221.
[6] Revenue Act of 1918, § 237.
[7] Revenue Act of 1918, § 221; Reg. 45, Art. 361.
[7a] Letter from Treasury Department dated November 20, 1919; I. T. S. 1919. ¶ 3651.

engaged in trade or business within the United States and not having any office or place of business therein.[8] The term "withholding agent" means any person required to deduct and withhold any tax required to be deducted and withheld by the law.[9] A withholding agent may be a corporation with bonds outstanding, a trustee under a corporate mortgage, or any corporation, partnership or private individual.[10] The term "bond interest," as used in this chapter, means obligations of domestic corporations.[11] The term does not include interest payments on ordinary bankable commercial paper of corporations or ordinary promissory notes of corporations not exceeding one year in time.[12] The term "covenant to pay the tax," means a covenant, contract or provision in the bonds, mortgage, deed of trust or other similar obligations of a corporation by which the obligor agrees to pay any portion of the income tax imposed by the Revenue Act of 1918 upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[13]

Fixed or Determinable Annual or Periodical Income. The phrase "fixed or determinable annual or periodical" income expressly includes interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but expressly excludes income received as dividends from a corporation taxable upon its net income. It also expressly excludes interest on bonds, mortgages or similar obligations of corporations containing covenants to pay any portion of the tax.[14] Only (a) fixed or determinable (b) annual or periodical income is subject to withholding. Among such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. But other kinds of income may be included. Income is fixed when it is to be paid in amounts definitely pre-de-

8 Revenue Act of 1918, § 237.
9 Revenue Act of 1918, § 200.
10 Reg. 45, Art. 1533.
11 Revenue Act of 1918, § 221.
12 T. D. 2090.
13 Revenue Act of 1918, § 221.
14 Revenue Act of 1918, § 221.

termined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical.[15] In the following paragraph the term is defined in its various aspects.

SALARIES. Per diem salaries paid on a straight basis of compensation for services rendered are fixed or determinable annual or periodical income, unless the employee is required by the terms of his employment or contract to pay therefrom his own traveling and other legitimate expenses incident to the business of his employment.[16] It is held that salaries, wages and commissions, paid by domestic business enterprises to non-resident alien employees for service rendered entirely in a foreign country are not income in the hands of the recipient as from a source within the United States. They are, therefore, not subject to withholding at the source.[17]

PARTNERSHIP SALARIES. Salaries stipulated by contract or articles of agreement between partnership members constitute fixed or determinable and annual or periodical income. But where, by agreement or otherwise, members of a firm are permitted to draw either stated or unstated sums in advance of an annual or periodical determination of partnership profits, no withholding is required, as these sums do not represent fixed or determinable

15 Reg. 45, Art. 362; Revenue Act of 1918, §§ 221, 256. Income of farmers, merchants, agents (unless the compensation is in the form of commissions), lawyers (except annual retainers), doctors, authors, inventors, and other professional persons, whose income is irregular or indefinite, is not fixed or determinable and annual or periodical and is not, therefore, subject to withholding. (T. D. 1890; T. D. 2090.) Although payments of income which is not fixed or determinable and annual or periodical are not subject to withholding, a resident in this country having the receipt, control, or custody of such income may be required, *as agent* for the non-resident principal owner, to report the amount of such income and to account for any and all tax, normal and additional thereon. (Reg. 45, Art. 404.) See p. 56.

16 T. D. 2135.

17 Reg. 45, Art. 92; Reg. 33 Rev., Art. 32.

income within the meaning of the law.[18] Withholding seems to be required against non-resident alien partners on payment of the net distributive shares of the income of a partnership although the regulations do not expressly so state.

COMMISSIONS. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income.[19]

PROFIT SHARINGS. Payments constituting a share of the profits of the employer are fixed or determinable and annual or periodical income.[20]

BONUS. A bonus paid in addition to salary is fixed or determinable income,[21] unless it is a mere gift or gratuity.

DIVIDENDS. The withholding of the tax at the source is not required in the case of income received as dividends from a corporation which is taxable upon its net income. Distributions by a personal service corporation, are, however, subject to the deduction of the tax at the source.[22]

INTEREST. Interest as a general rule is held to be fixed or determinable and annual or periodical income and subject to withholding,[23] and banks are required to withhold the tax on interest paid to non-resident alien individuals or non-resident foreign corporations.[24] In many cases the accounts of foreign banks hav-

18 Memorandum from Treasury Department, I. T. S. 1917, ¶ 2282. See Reg. 45, Art. 362.

19 Reg. 45, Art. 362. Under the 1916 Law the Treasury Department has distinguished between an individual working on a straight commission basis and, in earning his commissions, incurring and personally paying traveling and other expenses, the amounts paid to such an individual as commissions not being regarded as fixed or determinable annual or periodical income, and an individual incurring and paying no necessary business expenses in earning his commissions, the amounts paid him being regarded as fixed and determinable annual or periodical income. (Letter from Treasury Department dated January 12, 1917; I. T. S. ¶ 1016.)

20 T. D. 2090.

21 T. D. 2135.

22 Revenue Act of 1918, § 221; Reg. 45, Arts. 361, 363.

23 Letter from Treasury Department dated April 22, 1919; I. T. S. 1919, ¶ 3314; Telegram from Treasury Department dated May 23, 1919; I. T. S. 1919, ¶ 3342; Reg. 33, Art. 67.

24 Letter from Treasury Department dated April 22, 1919; I. T. S. 1919, ¶ 3314. T. D. 2652. Although these rulings expressly stated that withholding was required only with respect to interest paid to non-resident aliens, the

ing balances on deposit in domestic banks are at times overdrawn and instead of crediting interest to their accounts the domestic bank is obliged to debit interest for the money temporarily advanced to the foreign bank. In some cases foreign banks have two accounts with domestic banks, one a deposit account, and the other a borrowing account. In such cases domestic banks are required to deduct and withhold the tax from the entire amount of interest credited to foreign banks upon their deposits in the domestic banks regardless of the amount of interest charged the foreign banks on money advanced to them through loans on borrowed accounts or on account of overdrafts or otherwise. However, if the foreign banks render returns of their total income from all sources within the United States they may deduct in such returns the interest charged upon the money advanced to them by the domestic banks to the extent allowed by the Revenue Act of 1918.[25] In such cases the foreign bank should include in its gross income the entire amount of the income from which the tax was withheld and paid at the source, as well as income from all other sources within the United States, without deduction for the tax so paid, but any tax actually so withheld is to be credited against the total tax as computed in this return. In the event that the amount of tax so paid at the source by the withholding agent is in excess of the total tax liability of the foreign bank a claim for refund may be filed for the amount overpaid.[26] Interest on bonds is treated in a subsequent paragraph.

MERCANTILE ACCOUNTS CURRENT. Interest accruing on mercantile accounts current or upon moneys held on deposit for non-resident alien individuals, or non-resident foreign corporations if the principal amounts so due as well as the interest are at all times subject to call and payable on demand, is fixed or deter-

reason for limiting the rulings to individuals does not exist under the 1918 Law. (Telegram from Treasury Department dated May 23, 1919; I. T. S. 1919, ¶ 3342.) The long established rule that banks were not required to withhold on interest paid or accruing on deposits was revoked by T. D. 2652. It seems that the word "paid," as used therein, is intended to include interest which is actually paid and also interest that is credited to the account of non-resident alien individuals, that is, deduction is to take place when the interest is placed at the depositor's credit.

25 See Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

26 Letter from Treasury Department dated July 26, 1919, I. T. S. 1919, ¶ 3507.

minable and annual or periodical income and should be deducted at the source.[27]

Rent. Rent is fixed or determinable and annual or periodical income subject to withholding, and this is true whether payment is made in cash or in notes.[28] Where permanent improvements are made by a tenant under the terms of a lease the value thereof is considered income to the landlord to be accounted for at the termination of the lease, but the amount is not fixed or determinable income.[29] Rent paid by domestic business enterprises to non-resident aliens for property located in a foreign country is not subject to tax as income from sources within the United States and is, therefore, not subject to collection at the source.[30]

Royalties. Where royalties or rentals accrue under the terms of a lease or agreement, as for instance, royalties for the right to mine or remove minerals or other natural deposits, the royalties or rentals are not fixed or determinable and annual or periodical income if they represent a partial return of capital originally invested in the lands by the lessor.[31]

Promissory Notes. When a note is given in payment of fixed or determinable and annual or periodical income the duty of withholding the tax is imposed upon the maker of the note.[32]

Exempt Income. Although exempt income may be fixed or determinable and annual or periodical, no withholding is required upon the payment thereof.[33]

Bond Interest. The rate of tax to be withheld and the duty of withholding upon the payment of bond interest to non-resident aliens and non-resident foreign corporations depends upon whether the bonds upon which the interest is paid contain or do not contain a covenant to pay the tax, and upon whether the owner of the bonds in question is known. The rates of tax and

[27] Letter from Treasury Department dated April 22, 1919; I. T. S. 1919, ¶ 3314; see telegram from Treasury Department dated May 23, 1919; I. T. S. 1919, ¶ 3342.

[28] T. D. 2090.

[29] T. D. 2442.

[30] Reg. 45, Art. 92; Reg. 33 Rev., Art. 32.

[31] Letter from Treasury Department dated March 10, 1916; I. T. S. 1919, ¶ 571.

[32] Reg. 33, Art. 68.

[33] T. D. 1890.

the rules respecting the withholding of interest paid upon both classes of bonds are given in the following paragraphs.

INTEREST UPON BONDS NOT CONTAINING TAX-FREE COVENANT. Interest paid in 1918 and thereafter upon bonds not containing a tax-free covenant is subject to withholding at the rate of 8% in the case of non-resident aliens and 10% in the case of non-resident foreign corporations. No tax is required to be withheld from such interest when the bonds in question are owned by non-resident foreign partnerships.[34] The tax should be withheld from such interest payments at the rates in force for the year in which payment is actually made, notwithstanding the interest represents income for the year in which the coupons become due and payable. This is true even though interest coupons which have matured but which have not been cashed represent gross income for the year of maturity because the Revenue Act of 1918 provides that the withholding agent must withhold at the rates prescribed by the present law in the case of every payment made after February 24, 1919, and the tax must be withheld from the whole payment, not merely that part which applies to the period after February 24, 1919. In case an amount of tax is withheld beyond the tax liability of the taxpayer the excess will be refunded upon application.[35] Owing to the German occupation of Belgium during the war and to the general unsettled conditions in different parts of Europe, it has been impossible for foreign owners of American securities to deposit coupons for collection when they became due during the years 1915, 1916, 1917 and 1918. Such coupons were presented for collection in large quantities in the year 1919. In such cases the amount of the coupons should have been entered as income on the returns of the various recipients for the years in which coupons matured, but the withholding agent was required to withhold the tax from these coupons at the rate in force at the time of payment.[36] No

[34] Letter from Treasury Department dated April 18, 1919; I. T. S. 1919, ¶ 3318.

[35] Letter from Treasury Department dated September 23, 1919; I. T. S. 1919, ¶ 3576, modifying letter from Treasury Department dated September 5, 1919; I. T. S. 1919, ¶ 3551. See also telegram from Treasury Department dated June 9, 1919; I. T. S. 1919, ¶ 3431; telegram from Treasury Department dated September 8, 1919; I. T. S. 1919, ¶ 3569.

[36] Letter from Treasury Department dated September 23, 1919; I. T. S. 1919, ¶ 3576.

tax is required to be withheld from payments of interest upon bonds due prior to March 1, 1913, but paid subsequently to that date.[37] Bonds not containing a tax-free covenant are not permitted to be considered tax-free bonds at the option of the issuing corporations, and the issuing corporations are prohibited from paying the tax on interest derived from such bonds, when they are owned by citizens or residents of the United States.[38]

INTEREST UPON BONDS CONTAINING A TAX-FREE COVENANT. In any case where bonds, mortgages, deeds of trust, or other similar obligations of a corporation contain a covenant, contract, or provision by which the obligor agrees to pay any portion of the income tax imposed by the Revenue Act of 1918 upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the corporation or its withholding agent is required to deduct and withhold a tax equal to 2% of the interest if paid to (a) an individual whether citizen or resident or non-resident alien, (b) a partnership, whether domestic or foreign, resident or non-resident, and (c) a non-resident foreign corporation.[39] In all such cases the tax to be withheld is at the rate of 2% of the interest paid regardless of the status of the payee. Although the law requires the deduction of the tax at higher rates in the case of payments of other income to non-resident aliens and non-resident foreign corporations, only 2% is withheld and the recipient of the interest is required to account in his personal return for the remainder of the tax that may be due thereon. The corporation is relieved from withholding in the case of interest payments on such bonds only when the citizen or resident entitled to receive such interest files with the withholding agent on or before February 1 of the year following that in which the interest is received a

37 Telegram from Treasury Department dated August 26, 1919; I. T. S. 1919, ¶ 3547.

38 Telegram from Treasury Department dated June 2, 1919; I. T. S. 1919, ¶ 3471.

39 Revenue Act of 1918, § 221 and § 237. This provision is inserted in the law for the purpose of shifting the burden of the tax from the bondholder to the debtor corporation, a burden the corporation would generally not be required to assume were it not for the withholding provision.

signed notice in writing claiming the benefit of the personal exemption for dependents specified in Section 216 of the law, or both. In the case of non-resident aliens withholding is at present required regardless of whether or not the non-resident alien may in his personal return be allowed to claim the personal exemption.[40] The practical effect of these provisions of the law is that where a corporation has issued bonds containing a covenant to pay the tax, it will be required to go through the motions of withholding 2% on all payments to bondholders other than domestic corporations and resident foreign corporations, unless in the case of citizens or residents a certificate is filed claiming exemption from the tax on such income. No tax will actually be withheld, since the interest will be paid in full under the terms of the covenant, and the corporation will pay a tax equivalent to the amount theoretically withheld. The recipient of the interest will report in his return of income the full amount of the interest received but he will deduct from the amount of tax otherwise payable thereon a sum equal to 2% of the total amount of such interest. Recent rulings also require that he add to his income the amount of the tax so paid for him on the theory that it is additional interest.[40a] If a citizen or resident is not subject to the income tax by reason of the personal exemption to which he is entitled, he should file with the debtor corporation on or before February 1, of the year following that in which the interest was paid, a certificate claiming exemption, as otherwise he will subject the paying corporation to the expense of 2% of the amount of the interest paid him, although no tax is due thereon.

CAR-TRUST CERTIFICATES. Car-trust certificates are held to be obligations similar to corporate bonds and mortgages. The trustees are, therefore, required to withhold the tax at the rate of 2% if the certificates contain a covenant, contract, or provision by which the obligor agrees to pay any portion of the income tax imposed upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[41]

UNKNOWN OWNERS. Withholding in all cases at the highest

[40] Revenue Act of 1918, § 221; Reg. 45, Art. 362.
[40a] Reg. 45, Art. 31.
[41] Reg. 33 Rev., Art. 188.

applicable rate is required from interest on bonds or other securities where the owner of such securities is unknown to the withholding agent.[42] The "highest applicable rate" is (a) 2% of interest upon bonds or other obligations of domestic or resident foreign corporations containing a tax-free covenant clause, (b) 8% in the case of fixed or determinable annual or periodical income (other than dividends from corporations liable to the income tax and interest on corporate bonds containing a tax-free covenant) payable to an unknown owner.[43]

Against Whom the Tax Is Withheld. Although the foregoing paragraphs indicate the classes of taxpayers against whom a tax is withheld the law will be restated under this heading for the sake of convenient reference.

Citizens and Residents. No tax is withheld on payments to citizens and residents except in cases where interest is paid upon any bonds, mortgages, deeds of trust, or similar obligations of corporations containing covenants to pay the tax, in which case the tax is required to be withheld at the rate of 2%.

Citizens of United States Possessions. The income of a citizen of a possession of the United States, who is not otherwise a citizen or a resident of the United States, from sources within the United States, is subject to withholding.[44]

Non-Resident Aliens. In the case of payments of interest upon bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. In all other cases where payment is made of fixed or determinable annual or periodical income the tax is withheld at the rate of 8%.

Fiduciaries. The tax is withheld on payments of bond interest to fiduciaries who are citizens or residents of the United States and who have an office or place of business therein in the same manner and to the same extent as in the case of citizens and residents, whether the fiduciary is an individual or corporation. The

42 Reg. 45, Art. 361.

43 Letter from Treasury Department dated June 2, 1919; I. T. S. 1919, ¶ 3383; letter from Treasury Department dated April 18, 1919; I. T. S. 1919, ¶ 3318. This ruling seems to ignore the fact that 10% should be withheld if the owner is a foreign corporation, which rate might well be taken to be the "highest applicable rate" as to all income subject to withholding, except interest on tax-free covenant bonds.

44 Reg. 45, Art. 1121.

tax is withheld on payments to foreign fiduciaries in the same manner and to the same extent as in the case of non-resident aliens whether the fiduciary is an individual or a corporation. Fiduciaries are subject to all the provisions of the law which apply to individuals.[45]

PARTNERSHIPS. On payments to partnerships, whether domestic or foreign, resident or non-resident, of interest upon bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. No tax is withheld on payment of any other form of income.[46]

PERSONAL SERVICE CORPORATIONS. Personal service corporations, after receiving notice from the Commissioner that their returns as personal service corporations have been approved, but not before, may for purposes of withholding proceed as partnerships in claiming exemptions and in obtaining the benefit of having the tax paid for them under tax-free covenants.[46a]

CORPORATIONS. No tax is withheld in any case on payment of income to domestic corporations or to resident foreign corporations. In the case of non-resident foreign corporations the tax is withheld at the rate of 2% on all payments of interest upon bonds of corporations containing covenants to pay the tax; and at the rate of 10% on all other fixed or determinable annual or periodical income.[47] For the purpose of withholding, a Porto Rican corporation is a foreign corporation.[48]

AGENTS. The fact that an individual, partnership or corporation may have an agent within this country to collect and receive income, does not operate to prevent withholding of the tax on payments of income to such agent in cases where payments direct to the principal would be subject to withholding. The appointment of an agent in this country does not, in itself, establish the residence of the principal in this country, for the purpose of the income tax, nor does such appointment exempt a non-resident foreign corporation from the withholding provisions unless, in addition to the appointment of the agent, the corporation is en-

[45] Revenue Act of 1918, § 225 and § 221; Reg. 45, Art. 374.

[46] Revenue Act of 1918, § 221; Reg. 45, Art. 361.

[46a] Letter from Treasury Department dated November 20, 1919; I. T. S. 1919, ¶ 3651.

[47] Revenue Act of 1918, §§ 221 and 237; Reg. 45, Art. 361.

[48] Reg. 45, Art. 1136.

gaged in business in this country or has an office or place of business herein. Agents of non-resident aliens, or foreign corporations subject to the withholding provision should proceed, in collecting income from their principals, in the same manner as the principals would proceed in acting for themselves.

Who Are Required to Withhold Tax. Under the 1918 Law it is required that all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income shall withhold the tax, when withholding is required by reason of the status of the recipient of the income.[49] It has been held that a foreign corporation having a fiscal agency in this country is required to withhold a tax of 2% upon the interest upon its tax-free covenant bonds.[50]

DUTY OF EMPLOYER TO DETERMINE STATUS OF ALIEN EMPLOYEES. Employers are responsible for the deduction of the tax at the source on payments of salary or compensation to non-resident alien employees. This was first required in September, 1915.[51] No effort will be made to hold employers of non-resident aliens liable for tax prior to September 17, 1915, when the term "non-resident alien" was defined by the Treasury Department and not then if such non-resident alien had been employed continuously by the same person or corporation for a period of three months or more. Aliens employed in the United States are *prima facie* regarded as non-residents for the purpose of withholding. If wages are paid without withholding the tax the employer should be provided with written proof of facts which overcome

49 Revenue Act of 1918, §§ 221, 237.

50 Reg. 45, Art. 361; letters from Treasury Department dated July 9, 1918 (I. T. S. 1918, ¶ 3612) and July 18, 1918 (I. T. S. 1918, ¶ 3613).

51 Letter from Treasury Department dated May 21, 1919; I. T. S. 1919, ¶ 3394. See T. D. 2242 issued on the date mentioned in the text above. Withholding after February 25, 1919, should be at the rate of 8 per cent. Although non-resident aliens were subject to a normal tax of 12 per cent for 1918, only 2 per cent was required to be withheld during that year, the balance due to be accounted for in the individual income tax returns.

the presumption that the alien is a non-resident. Such presumption may be overcome in one of two ways: (a) If an alien has been living in the United States for as much as one year immediately prior to the time he entered the employment of the withholding agent, or if he has been regularly employed by an individual resident in the United States or by a resident corporation in the same city or county for as much as three months immediately prior to any payment by the employer, he may be treated as a resident in the absence of facts known to the employer showing that he is in fact a transient.[52] The facts with regard to the length of time the alien has thus lived in the city or county and has been so regularly employed may be established by the certificate of the alien. (b) The employer may also obtain evidence to overcome the *prima facie* presumption of non-residence by securing from the alien Form 1078 (revised) or an equivalent certificate of the alien establishing residence.[53] A record of such forms of certificates should be kept by every employer and the certificates forwarded to the Commissioner (Sorting Division, Washington, D. C.) not later than the twentieth day of the month succeeding that during which they were received.[54] Having secured such evidence from the alien, the employer may rely thereon unless the statement of the alien was false and the employer has reasonable cause to believe it false, and may continue to rely thereon until the alien ceases to be a resident.[55] An employer who seeks to

[52] A typical transient is one who stops for a short time in the course of a journey through the United States, sometimes performing labor, sometimes not, or one who enters the United States intending only to stop long enough to carry out some purpose, object, or plan not involving an extended stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute an alien a transient. (Reg. 45, Art. 312; T. D. 2794.)

[53] If an officer, qualified to administer oaths, is not reasonably accessible, Form 1078 (Revised), will be accepted if signed in the presence of an official of the employer company under whose supervision the employee's duties are performed, and one other credible witness. (Letter from Treasury Department dated September 20, 1919; I. T. S. 1919, ¶ 3612.)

[54] Letter from Treasury Department dated May 21, 1919; I. T. S. 1919, ¶ 3394; Letter from Treasury Department dated July 9, 1919; I. T. S. 1919, ¶ 3492.

[55] The employer may continue to rely thereon until the alien ceases to be a resident; it is not necessary to secure new certificates for each taxable year. (Letter from Treasury Department dated July 9, 1919; I. T. S. 1919, ¶ 3492. An alien who has established a residence in the United States continues to be a

account for failure to withhold the required tax and who did not at the time secure Form 1078 (revised) or its equivalent, is permitted to prove the former status of the alien by any material evidence. The burden of proof in such cases is on the employer and such proof must be in writing. Hence the name and address of employees should be secured, regardless of the fact that for the convenience of the employer the individual is known by number.[56] In the case of alien seamen, the regulations provide that residence may be established on a vessel regularly engaged in coastwise trade.[57] This provision, however, merely places alien seamen employed on a vessel regularly engaged in coastwise trade on the same footing with an alien employed within the United States for purposes of proving residence within the United States. The employer should, therefore, be governed by the above requirements with respect to the necessity for filing Form 1078 (Revised).[58]

EMPLOYEES OF MINING CONTRACTORS—"BACK HANDS." It is customary in a great many mining districts to let out a certain portion of a mine to some miner who is usually termed a contractor, who employs additional labor for the production of coal for the section of the mine assigned to him. These men, usually termed "back hands," sometimes do not appear upon the pay-roll and are very frequently not officially known to an operator or employer. The operator frequently does not know the amount of earnings of the "back hand" or laborer employed by the contractor and the latter usually keeps no books of account. In such cases the duty of withholding the tax at the source is that of the contractor and not of the corporation.[59]

CHANGE OF STATUS OF EMPLOYEE. Where the status of an alien changes during the year from that of resident to that of non-resident, or from that of a non-resident to that of resident, the

resident until he or his family evidence an intention to change their residence to another country by starting to remove.) (Reg. 45, Art. 314; T. D. 2794.)

56 Reg. 45, Art. 315; T. D. 2794; Letter from Treasury Department dated May 26, 1919; I. T. S. 1919, ¶ 3398.

57 Reg. 45, Art. 312.

58 Letter from Treasury Department dated September 20, 1919; I. T. S. 1919, ¶ 3611.

59 Letter from Treasury Department dated May 26, 1919; I. T. S. 1919, ¶ 3398.

status which exists at the end of the taxable year is the one which determines his right to exemption as to the whole year. Where an employer has withheld wages from a non-resident alien during part of the year and thereafter the employee becomes a resident (before the employer has paid over to the United States the amount of tax withheld), the employer is authorized on receiving proof of the change, to refund to the employee the amounts which had been withheld from him during the earlier part of the taxable year, while his status was that of a non-resident. If the status of a resident employee changes to that of a non-resident alien, the employer should withhold the tax at the rate of 8% from all wages or compensation paid to such employee on and after the date on which the employer has knowledge of the change. Although an employee in such case will be taxable as a non-resident alien for the entire taxable year during which his status is changed from that of a resident to that of a non-resident alien, the employer will not be held liable for the deduction of the tax with respect to wages paid prior to the knowledge of the employer as to the change in status.[60]

Duties of Assignees. Where in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, corporation, or a state or political subdivision thereof, must deduct and withhold such taxes as would have been required to be withheld by the assignor had no such sale and transfer been made.[61]

Exemption from Withholding. Withholding from interest on bonds or other obligations containing a tax-free covenant will not be required in the case of a citizen or resident alien individual if he files with the withholding agent when presenting interest coupons for payment, or not later than February first following the taxable year, an ownership certificate on Form 1001 (Revised) claiming a personal exemption or credit for dependents. To avoid inconvenience a resident alien individual should file a certificate of residence on Form 1078 (Revised) with withholding agents, who should forward such certificates to the Commissioner (Sorting

[60] Letter from Treasury Department dated August 6, 1919; I. T. S. 1919, ¶ 3525; letter from Treasury Department dated June 12, 1919; I. T. S. 1919, ¶ 3436.

[61] Reg. 45, Art. 364.

Division) with a letter of transmittal.[62] The extent to which non-resident aliens may secure exemption from withholding as against any income from sources within the United States up to the amount of any personal exemption and credit for dependents which may be allowed to them under the similar credit provision of the statute is discussed elsewhere.[63]

Ownership Certificates. The owners of bonds or other obligations, whether or not containing a tax-free covenant, issued by domestic or resident foreign corporations, when presenting interest coupons for payment, are required to file a certificate of ownership for each issue of bonds, showing the name and address of the debtor corporation, the name and address of the owner of the bonds, whether the payee is married or the head of a family, the nature of the obligations, the amount of interest and its due date, and the amount of any tax withheld. No ownership certificates need be filed in the case of interest payments on bonds the income from which is not included in gross income, nor in the case of any obligations of the United States.[64] All the information called for by ownership certificates is necessary for the efficient administration of the Revenue Act. Debtor corporations will be held responsible for the proper execution of certificates, but not as to misstatements by bond owners. Ownership certificates should not be accepted and payments should be refused unless all information called for thereon is shown, including information as to whether the payee is married or the head of a family.[65] Interrogatories as to the marital status on ownership certificates need not be answered when certificates are executed by non-resident alien individuals.[66] Ownership certificates executed by the owner must indicate whether or not he is married or the head of a family.[67] But if he states that he is married it is not

62 Reg. 45, Art. 363.

63 See Chapter 31.

64 Reg. 45, Art. 364.

65 Telegram from Treasury Department dated April 7, 1919; I. T. S. 1919, ¶ 3293; telegram from Treasury Department dated February 28, 1918; I. T. S. 1918, ¶ 3146.

66 Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3380.

67 Letter from Treasury Department dated March 26, 1918; I. T. S. 1919, ¶¶ 660, 670, 675.

also necessary that he state that he is head of a family.[68] The address may be omitted from ownership certificates in the case of prominent corporations and in its place a description of the bond issue may be inserted.[69] Separate ownership certificates will be required for each interest coupon of different maturity date even though of the same issue.[70]

FORMS OF OWNERSHIP CERTIFICATES. The following is a list of the latest revisions of ownership certificates:

Form	1000	Revised	May, 1919
"	1001	"	May, 1919
"	1001A	"	February, 1919
"	1058	"	February, 1919
"	1059	"	February, 1919
"	1087	"	April, 1919

Form 1071 is now obsolete, Form 1001A being used in its place. In view of the fact that the revised forms of ownership certificates have been at the disposal of the public for some time, the public has had reasonable opportunity to become familiar with them. In order, however, to prevent inconvenience to individuals and organizations required to use such forms, old forms of ownership certificates will be accepted with respect to interest due on and prior to November 1, 1919, when received from continental United States, and with respect to interest due on and prior to December 1, 1919, when received from abroad. Banks and collecting agents, debtor corporations, and witholding agents will refuse to accept the old forms, in connection with interest due after the respective dates named above, and collectors receiving monthly returns accompanied by certificates on the old forms, when it shall appear that such certificates were filed with debtor corporations or withholding agents with respect to interest due subsequent to such dates, will require the debtor corporation or withholding agent concerned to secure certificates on the revised forms.[71]

68 Letter from Treasury Department dated March 30, 1918; I. T. S. 1919, ¶ 671.

69 Telegram from Treasury Department dated February 11, 1918; I. T. S. 1919, ¶ 665.

70 Telegram from Treasury Department dated June 24, 1919; I. T. S. 1919, ¶ 3470.

71 T. D. 2923. See telegram from Treasury Department dated September 29, 1919; I. T. S. 1919, ¶ 3590. The form number and date of revision will be found in the upper left hand corner of all certificates.

Rules for Use of Forms. As a general rule, Form 1000 is used when withholding is required and Form 1001 is used when no withholding is required. Forms 1058 and 1059 are substitute certificates to be used as indicated below in the place of the original ownership certificates which are sent to Washington. Form 1058 is used in lieu of original ownership certificate Form 1001, and Form 1059 is used in lieu of original ownership certificate Form 1000. The use of Form 1087 is indicated in another chapter.[72] Form 1001 A is used in connection with foreign items, as defined above. The following is a table indicating the particular form of ownership or substitute certificates to be used in particular cases, as stated in the text following the table.

TABLE FOR USE OF OWNERSHIP AND SUBSTITUTE CERTIFICATES.[1]

	Ownership Certificates			Substitute Certificates	
	Bonds of Domestic or Resident Foreign Corporations		Foreign Items[2]	With Tax-Free Covenant	Without Tax-Free Covenant
	With Tax-Free Covenant	Without Tax-Free Covenant			
Citizen or Resident.					
Individual or fiduciary claiming exemption	1001[6]	1001	1001 A	1058	1058
Individual or fiduciary not claiming exemption	1000		1000 or 1001 A[3]	1059	1058
Partnership and Personal Service Corporations[7]	1000	1001	1000 or 1001 A[3]	1059	1058
Corporation	1001	1001	1001 A	1058	1058
Non-Resident Alien.					
Individual or fiduciary	1000	1000	1001 A	None Permitted	None Permitted
Partnership	1000	1001	1001 A	None Permitted	None Permitted
Corporation[5]	1000	1000	1001 A	None Permitted	None Permitted
Banks Receiving Coupons not Accompanied by Ownership Certificates—Ownership Unknown	1000	1000	1000[4]	....	....
Foreign Governments and Foreign Charitable or Exempt Corporations	1001	1001	....	....	....

[1] See Reg. 45, Arts. 365-7, 1078; Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, ¶ 3338; Telegram from Treasury Department dated July 7, 1919; I. T. S. 1919, ¶ 3474.

[2] The term "foreign item," as here used, means any dividend upon the stock of a non-resident foreign corporation or any item of interest upon the bonds of foreign countries or non-resident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank. (Reg. 45, Art. 1077.)

[3] 1000 is used in this instance if the foreign country or foreign corporation has a fiscal agent in this country and if the bonds contain a tax-free covenant clause, unless exemption is claimed. (Reg. 45, Art. 1078; Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, ¶ 3338.)

[4] 1001 A is used in this instance if the owner is known to be a non-resident alien individual, corporation, or partnership.

[5] A foreign corporation not engaged in trade or business within the United States, which has a fiscal agent in the United States, is not a resident corporation. (Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, ¶ 3338.)

[6] In the case of registered bonds having a tax-free covenant 1000 is used by the withholding agent if the owner files no certificate. That is, if the owner files no certificate the withholding agent must presume that he does not claim exemption from withholding. (Reg. 45, Art. 369.)

[7] Before a corporation can be regarded as a personal service corporation it must have received notice from the Commissioner that its claim to be regarded as a personal service corporation has been approved. (Letter from Treasury Department, dated November 20, 1919; I. T. S. 1919, ¶ 3651.)

Form of Certificate Where Withholding Required. Form 1000 (Revised) should be used (a) by citizens or residents of the

[72] See Chapter 5.

United States when no personal exemption or credit is claimed against interest on bonds containing a tax-free covenant; (b) by non-resident alien individuals and non-resident foreign corporations, whether or not such bonds contain a tax-free covenant; (c) by partnerships, resident or non-resident, in the case of bonds containing a tax-free covenant.[73]

FORM OF CERTIFICATE WHERE NO WITHHOLDING REQUIRED. Form 1001 (Revised) should be used (a) by citizens or residents of the United States when personal exemption is claimed against interest on bonds containing a tax-free covenant and when presenting coupons from bonds not containing a tax-free covenant; (b) by domestic corporations; (c) by partnerships, resident or non-resident, in the case of bonds not containing a tax-free covenant; and (d) by resident foreign corporations, whether or not such bonds contain a tax-free covenant. In case a citizen or resident alien individual receives interest on bonds containing a tax-free covenant in excess of the amount of personal exemption which the individual may claim, any such excess must be reported on Form 1000 (Revised).[74] That is, he cannot claim exemption from withholding with respect to an amount greater than his personal exemption even though he may want to relieve the paying corporation of the contract duty to assume the burden of the tax on his behalf.

USE OF SUBSTITUTE CERTIFICATES. Resident collecting agents, responsible banks and bankers, receiving interest coupons for collection with ownership certificates attached, may present the coupons with the original certificates to the debtor corporation or its duly authorized withholding agent for collection or may detach and forward the original certificates direct to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates—Form 1058 (Revised) or Form 1059 (Revised)—and shall keep a complete record of each transaction, showing (a) serial number of item received; (b) date received; (c) name and address of person from whom received; (d) name of debtor corporation; (e) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (f) face amount of coupons. For the purpose of iden-

[73] Reg. 45, Art. 365.
[74] Reg. 45, Art. 366.

tification the substitute certificates shall be numbered consecutively and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks and bankers is not permitted, however, in the case of ownership certificates presented with coupons for collection by non-resident alien individuals, partnerships, or corporations.[75] Substitute certificates may be used in connection with payments of income made to the alien property custodian.[76]

INTEREST COUPONS WITHOUT OWNERSHIP CERTIFICATES. Where interest coupons are received unaccompanied by certificates of ownership the first bank should require of the payee an affidavit showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a statement that the owner of the bonds is unknown to the payee. Such affidavit should be forwarded to the collector with the monthly return on Form 1012 (Revised). The first bank receiving such coupons should also prepare a certificate on Form 1000 (Revised), crossing out "owner" and inserting "payee" and entering the amount of interest in the space provided for a non-resident foreign corporation and should stamp or write across the face of the certificate "Affidavit furnished," adding the name of the bank.[77]

INTEREST ON REGISTERED BONDS. Where a bondholder files no ownership certificate in the case of payments of interest on registered bonds the withholding agent should make out such a certificate in each instance (a) on Form 1000 (Revised) if the bondholder is a citizen or resident of the United States or a resident or non-resident partnership and the bonds contain a tax-free covenant, or if the bondholder is a non-resident alien individual or a non-resident foreign corporation, and (b) on Form 1001 (Revised) in all other cases. When so used Forms 1000 (Revised) and 1001 (Revised) need not be signed.[78]

RETURN OF TAX WITHHELD. Every withholding agent is required to make an annual return to the collector, of the tax with-

[75] Id. Art. 367.

[76] Letter from Treasury Department dated June 6, 1918; I. T. S. 1919, ¶ 1522.

[77] Reg. 45, Art. 368.

[78] Reg. 45, Art. 369.

held from interest on corporate bonds or other obligations on or before March 1 on Form 1013 (Revised). He is also required to make a monthly return on Form 1012 (Revised) on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute certificates where authorized, must be forwarded to the collector with the monthly return. Every person required to deduct and withhold any tax from income other than such bond interest must make an annual return thereof to the collector on or before March 1 on Form 1042 (Revised), accompanied by a separate report on Form 1098 (Revised), for each non-resident alien individual or non-resident foreign corporation to whom income other than bond interest was paid during the previous taxable year. In every case of both classes the tax withheld must be paid on or before June 15 of each year to the collector.[79]

Release of Excess Tax Withheld. Any sum withheld for tax since December 31, 1917, in excess of the aggregate amount required under the terms of the Revenue Act of 1918, will be released by the withholding agent and paid over to the person from whom it was withheld or his proper representative. With reference to how a debtor corporation may release and pay over the amount of tax so withheld in a case where a bank or other collection agency detached the ownership certificate which accompanied an interest coupon and substituted its own certificate (Form 1059), which does not disclose the name and address of the bond owner, in such cases the withholding agent should request the bank or collection agency to disclose the name and address of the owner of the bonds, as shown by the original certificate, and it shall be the duty of the bank or collection agency to make such disclosure to the withholding agent. Where withholding agents have so released any excess of tax, an itemized statement showing the names, addresses and amounts refunded should be attached to the annual list returns (Form 1013), in order to reconcile any discrepancy between the aggregate amount of taxes returned as shown by the monthly list returns (Form 1012) and the aggregate amount as shown by the annual list return.[80] The 2%

[79] Reg. 45, Art. 370.
[80] Reg. 45, Art. 372.

tax withheld on dividends of domestic corporations during the year 1918 should be released in this manner.[81]

USE OF INFORMATION RETURN WHERE NO ACTUAL WITHHOLDING. Where a debtor corporation or its duly authorized withholding agent has made payments of interest on its bonds, but in certain instances has been required to withhold no tax, the ownership certificates on Form 1001 (Revised) filed in connection with such payments should be transmitted directly to the Commissioner (Sorting Division), accompanied by a return on Form 1096 A showing the number of ownership certificates thus transmitted and the total amount of interest paid. This return shall be made by the 20th day of each month following that for which the return is made and need not be sworn to. An annual return shall be forwarded to the Commissioner not later than March 15 of each year on Form 1096 B, on which shall be given a summary of the monthly returns. To the extent that there has been actual withholding of the tax, returns should be made.[82]

OWNERSHIP CERTIFICATES IN THE CASE OF FIDUCIARIES AND JOINT OWNERS. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. When bonds are owned jointly by several persons, a separate ownership certificate must be executed in behalf of each of the owners.[83]

Withholding in 1918. In the case of payments made prior to February 25, 1919, where a withholding agent pursuant to the Revenue Acts of 1916 and 1917 withheld only 2% from the income of non-resident alien individuals, he need return only such sum. In all such cases where a withholding agent withheld the tax pursuant to the Revenue Acts of 1916 and 1917 from the income of non-resident foreign corporations, he need return only the sum withheld, to an amount not in excess of the aggregate sum required to be withheld by the terms of the Revenue Act of 1918 from the income paid over by the withholding agent. In the

81 Letter from Treasury Department dated March 24, 1919; I. T. S. 1919, ¶ 3283.

82 Reg. 45, Art. 373. Return is made in this case in accordance with Reg. 45, Art. 370.

83 Reg. 45, Art. 374.

case of every payment made after February 24, 1919, the withholding agent must withhold at the rates prescribed by the present statute from the whole payment, not merely from that part which applies to the period after February 24, 1919.[84]

Withholding in the Case of Enemies. Payments made after October 6, 1917 to the alien property custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations containing a tax-free covenant where no exemption is claimed. The alien property custodian should use Form 1000 (Revised) in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001 (Revised). No distinction is to be made between payments directly to the alien property custodian and to his depositaries or between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the Trading with the Enemy Act, withholding is required as in the case of any nonresident alien not an enemy or ally of enemy.[85] Where ownership certificate Form 1000 or Form 1001 is executed to cover funds paid over to the Alien Property Custodian, the certificate is sufficiently complete if the name of the taxpayer and the trust number are given under the heading "owner of bonds" with the name and address of the enemy or ally of enemy concerned excluded.[86]

Return of Income From Which Tax Withheld. The entire amount of the income from which the tax was withheld should be included in gross income without deduction for such payment of the tax. But any tax actually so withheld will be credited against the total tax as computed in the taxpayer's return. If the tax is paid by the recipient of the income or by the withholding agent it will not be re-collected from the other, regardless of the orig-

[84] Reg. 45, Art. 371. This ruling does not affect the tax liability of the nonresident alien, who will be liable for the tax at the rates prescribed for 1918 and 1919, and should make returns accordingly. (Telegram from Treasury Department dated March 5, 1919; I. T. S. 1919, ¶ 3244.)

[85] Reg. 45, Art. 375.

[86] Letter from Treasury Department dated July 13, 1918; I. T. S. 1919, ¶ 1525.

inal liability therefor, and in such event no penalty will be asserted against either person where no fraud or purpose to evade payment is involved.[87]

[87] Reg. 45, Art. 376.

CHAPTER 41

COVENANTS TO PAY TAXES

Covenants to pay taxes are contained in bonds, mortgages, notes, leases, and similar instruments whereby it is stipulated, in general, that the debtor, lessee, or other payor shall pay the interest, rent, or other income without deduction for taxes. Many such covenants became operative under the 1913 Law, and the 1916 Law prior to its amendment by the Act of October 3, 1917, by reason of the requirement in those laws that the normal tax should be withheld at the source. They operate under the 1916 Law as amended and under the present law only in certain cases and to a limited extent. Such covenants for the purpose of this discussion may be divided into two classes: (1) those which are contained in bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, and (2) those contained in other instruments. Those contained in the second class operate only when the payee is a non-resident alien or a non-resident foreign corporation, unless the covenant is so broad that it imposes an obligation on the payor notwithstanding that the interest, rent, or other payments thereunder are made in full without deduction of any tax at the source. Covenants of the first class stated above may be of two kinds: (a) those which agree to assume the tax of the payee only to the extent that the interest specified in the obligation shall be paid in full, and (b) covenants which may be so broad in their terms as to obligate the debtor to reimburse the creditor for any tax which may be imposed upon him with respect to the interest after it has been received in full by the creditor. Covenants broad enough to fall within the second class are very unusual and are not covered by the discussion in this chapter. Those covenants to pay the tax which are embraced within the language of the statute[1] and discussed in this chapter are only those which have all the following qualifications: (a) they must be made by corporations; (b) they must be contained

[1] Revenue Act of 1918, § 221.

in bonds, mortgages, deeds of trust, or other similar obligations, and (c) they must be such as to bind the debtor corporation to pay some portion of the tax imposed by the Revenue Act of 1918 on the creditor, or to reimburse the creditor for any portion of the tax, or to pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon, or to retain therefrom, under any law of the United States. Where payment of interest is made under such covenants a tax equal to 2% of the interest is required to be withheld at the source if the owner of the obligations is (a) an individual, whether he is a citizen or alien, resident or non-resident; (b) a partnership, whether domestic or foreign, resident or non-resident; (c) a non-resident foreign corporation.[2] Withholding at the highest applicable rate is required from interest on bonds or other securities where the owner of such securities is unknown to the withholding agent. The term "highest applicable rate" means 2% in the case of tax-free covenant bonds and 8% in the case of bonds not containing such covenants.[3] The tax is not required to be withheld on payments to domestic corporations or to resident foreign corporations. It is required to be withheld on payments to a fiduciary although the fiduciary may be a corporation. The tax cannot be withheld except against payees specified in the statute. If the bond contains a covenant to pay the tax but the mortgage does not, or vice versa, the tax must be withheld under this provision.

Foreign Corporations—Definition. The term "non-resident foreign corporation" is used in this chapter to include corporations not engaged in trade or business within the United States and not having any office or place of business therein. Foreign corporations which are either engaged in business within the country or have an office or place of business therein are referred to as "resident foreign corporations."[4]

Rate of Tax to Be Withheld. If the covenant specifies that a tax of 1% will be paid, 2% must nevertheless be withheld; 1%

[2] Revenue Act of 1918, §§ 221, 237; Reg. 45. Art. 361.

[3] Reg. 45, Art. 361; Mimeograph letter from Treasury Department, No. 2143, dated June 2, 1919; I. T. S. 1919, ¶ 3383. This is the ruling notwithstanding that 10% is withheld in some cases against non-resident foreign corporations.

[4] See Revenue Act of 1918, § 237; Reg. 45, Art. 1509.

being assumed by the debtor corporation and the other 1% by the bondholder. In such cases only 99% of the full amount of interest should be paid to the bondholder. If the covenant specifies that more than 2% will be paid by the debtor corporation, only 2% may be withheld, the covenant being inoperative under the law with respect to any additional amount specified therein. In the case of payments to non-resident aliens or non-resident foreign corporations, only 2% may be withheld on obligations containing tax-free covenants, notwithstanding that on other income 8% or 10% is required to be withheld in such cases. Obligations of individuals or partnerships, whether or not containing tax-free covenants, do not require withholding at the 2% rate or at any rate against citizens, residents, domestic corporations, or resident foreign corporations. If the bond, mortgage, deed of trust, or similar obligation does not contain a contract or provision obligating the debtor (a) to pay some portion of the tax imposed by the Revenue Act of 1918 on the creditor, or (b) to reimburse the creditor for any portion of the tax, or (c) to pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon, or to retain therefrom, under the laws of the United States, the debtor corporation cannot voluntarily undertake to withhold the tax under this provision and thereby assume the tax for its bondholders. Obligations of corporations other than bonds, mortgages, deeds of trust or similar obligations do not require withholding at the 2% rate or at any rate against citizens, residents, domestic corporations or resident foreign corporations.[5]

Object of Withholding Provision in Case of Tax-Free Covenant Bonds. Withholding the tax at the source at the rate of 2% on interest paid upon obligations containing tax-free covenants is not a measure designed or intended to insure the collection of revenue, as is withholding at the source generally. It is a measure whereby corporations may be compelled to pay a part of the tax which would otherwise be imposed upon the bondholder. The provision is inserted in the law on the theory that since corporations have issued bonds, mortgages, deeds of trust, or similar obligations, agreeing to pay interest thereon in full without de-

[5] Telegram from Treasury Department dated June 2, 1919; I. T. S. 1919, ¶ 3471.

duction for any tax which might be required to be withheld at the source and that this provision has presumably influenced either the price at which the bonds or obligations were sold or their rate of interest, the law should compel the corporation to assume some part of the tax of the bondholder. Apparently the entire normal tax was deemed to be too great a burden and 2% was considered appropriate. No reason is advanced, however, for excluding domestic corporation bondholders from the benefits accruing to individual or partnership bondholders under "tax-free covenants." In the case of savings banks and insurance companies the advantage if given would inure ultimately to the benefit of depositors or policyholders.

Procedure of Corporation Issuing Tax-Free Covenant Bonds. Since there is a requirement in the law that a 2% tax be assumed by the corporation on interest paid to a large proportion of its bondholders where the bond contains a tax-free covenant, it becomes a matter of importance to officers of corporations to determine whether or not the covenants in the bonds, mortgages, deeds of trust, or similar obligations of their respective corporations are broad enough in general language, or specific enough, to require the assumption of the burden under the Revenue Act of 1918. Unless there is a legal obligation to pay the tax, or any part thereof, for the bondholder, the officers of the corporation may incur personal liability in making such payments, since the payment of the tax of a bondholder without legal compulsion would constitute a diversion of the funds of the corporation to which stockholders and creditors may object. Furthermore, the corporation may incur liability for not withholding the proper amount of tax on payments to non-resident aliens or non-resident foreign corporations. The law requires that if the bond contains a covenant to pay the tax, only 2% shall be withheld, and that if the bond or obligation does not contain [6] such a covenant, 8% shall be withheld on payments to non-resident aliens. There is no authority in the law for withholding 8% and assuming to pay all or only 2% for the bondholder. Either the obligation is one which requires withholding at the rate of 2% and the assumption of the tax by the corporation, or it is one which requires withholding at the rate of 8% on payments of interest to non-resident aliens

[6] Revenue Act of 1918, § 221.

and the assumption of no part of the tax by the corporation. An examination of the covenant in each mortgage or issue of corporate bonds or similar obligations is therefore essential.

Examples of Covenants to Pay Taxes. A covenant reading as follows does not require or authorize the corporation to assume any part of the income tax of its bondholders: "Both principal and interest of this bond are payable without deduction for any taxes, assessments or other governmental charges which the company may be required to pay thereon or authorized to retain therefrom under any present or future law or requirement of the United States of America (except any Federal Income Tax) or any State, county, municipality or other governmental subdivision thereof."[7] Many covenants to pay taxes were entered into prior to the enactment of the 1913 Law, and without contemplation of an income tax law requiring collection at the source. In such covenants no specific reference is made to an income tax and the force of the covenant with respect to the present income tax depends upon the general language used therein. One typical form reads as follows: "Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessment or assessments, or other Governmental charges, which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States, or of any state, county, municipality or other lawful taxing authority thereof." Whether this form of covenant requires the corporation to pay the income tax of the bondholder, or only such taxes as are imposed on the bond or interest, as such, is an unsettled question. In a recent case it was held that a clause in bonds issued by a corporation promising payment "without deduction from either such principal or interest, for any tax or taxes, which the Marion Hotel Company may be required to pay or retain therefrom, under any present or future law, the Marion Hotel Company agreeing to pay such tax or taxes," did not require the corporation to pay the Federal income tax of the bondholder which it retained from the payment of interest on the bonds, since the tax is not a tax on the bond, but a personal obligation of the bondholder, arising out of the possession of an

[7] Letter from Treasury Department dated November 21, 1917; I. T. S. 1919, ¶ 621.

income in excess of the exemptions and deductions allowed by such law.[8] The Supreme Court of Massachusetts in deciding whether the income tax came within the terms of a covenant by a lessee to pay "all taxes and assessments * * * upon or in respect of the rent * * * howsoever and to whomsoever assessed," held that the 1913 Law imposed the tax "in respect of the rent" and held that the language quoted was effective to compel the tenant to assume the tax of the landlord to the extent that the law required the amounts thereof to be withheld at the source.[9] Other covenants provide that the debtor "will pay the principal and interest of these bonds without deduction for taxes." It is questionable whether or not covenants of this kind are broad enough to include taxes upon the bondholder as well as taxes assessed against the corporation upon the mortgage or bond or interest. Where a lease provided that the lessee should "pay all taxes and assessments—upon the yearly payments herein agreed to be made by the party of the second part to the party of the first part—for the payment or collection of which taxes or assessments the said party of the first part would otherwise be liable or accountable under any lawful authority whatever;" and that the lessee "should pay all taxes, charges, levies, claims, liens and assessments of any and every kind, which during the continuance of the term hereby demised, shall, in pursuance of any lawful authority, be assessed or imposed upon the demised premises, or any part thereof—all payments required to be made by the party of the first part during the term of this indenture—shall be assumed and discharged by the party of the second part as if the party of the second part were primarily liable for same," it was held that the lessee was liable for the income tax of the lessor on the ground that it was the apparent intention of the

8 Urquhart v. Marion Hotel Co. (Ark.), 194 S. W. 1. The court referred to the early cases of Haight v. Railroad Co., 6 Wall. 15; Baltimore v. Baltimore R. R., 10 Wall. 543.

9 Suter v. Jordan Marsh Company, (Mass.), 113 N. E. 580. The court seemed to rest its decision in this case on the conclusion that the tax was levied upon the separate sources from which a part of the net income was derived. This conclusion appears to be against the weight of authority that the tax is on the person and not on his property. If such conclusion had been reached by the court the decision might have been different. See, however, Catawissa R. R. Co. v. Phila. & Reading Co., 255 Pa. 269, where the court held that the income tax was "imposed upon rental received by the lessor from the lessee."

parties that the lessor should receive the amounts stipulated as rent without deduction by reason of any tax, charge or assessment of any kind and that the language was sufficiently broad to cover the Federal income tax although not enacted at the time the lease was made.[10] In another case where a covenant provided that the specified rent should be paid "without any deduction, defalcation or abatement for any tax, charges or assessments whatsoever, * * * it being the express agreement of the said parties that the said covenantor, his heirs and assigns, shall pay all taxes whatsoever that shall hereafter be laid, levied or assessed by virtue of any law whatever, as well on the said hereby granted lot and buildings thereon erected or to be erected as on the said yearly rental now charged thereon," it was held that the covenant did impose an obligation upon the lessee to pay the Federal income tax since it was manifestly the intention of the parties, by this covenant, to secure to the grantor the full payment of the yearly rent without any deduction, defalcation or abatement for any taxes, charges or assessments whatsoever.[11] Again, where a lease provided that the lessee should "pay all taxes, charges and assessments * * * imposed under any existing or future law on the demised premises, or any part thereof, or on the business there carried on, or on the gross receipts or net, derived therefrom, or upon the capital stock of 'the lessor' or the dividends thereon, or upon the franchises of the said company, for the payment or collection of any of which said taxes the 'lessor' may otherwise become liable," it was held that the lessee was not required to pay the Federal income tax on the rental received by the lessor on the ground that such tax was not expressly mentioned and the covenant was not broad enough to discharge all liability for taxes of every kind for which the lessor should become primarily liable.[12] The cases referred to above are cases

10 Northern Pennsylvania R. R. Co. v. Philadelphia & Reading Ry. Co., 43 Pa. C. C. 150; aff'd 249 Pa. 326.

11 Van Beil v. Brogan, 65 Pa. Super. 384, reversing 23 D. R. 1055 (Dauphin County Court, Pa. 1914). Erlich v. Brogan, 262 Pa. 362.

12 Little Schuylkill, etc., Co. v. Philadelphia & Reading Ry. Co., 44 P. A. County Ct. Rep. 197, aff'd 69 Pa. Super. 122. Allocatur to the Supreme Court has been denied. It seems in this case the intention of the lessor was to have the lessee pay any and all taxes so that the net amount of the rental could be distributed without diminution to the stockholders, but the court held that the language of the covenant was not broad enough to accomplish this purpose.

which have been decided under the 1913 or 1916 Laws. Other cases arising under different statutes are referred to in the foot note.[18]

[18] Northern Trust Co. v. Buck, 263 Ill. 222, 104 N. E. 1114, Pettibone v. Smith, 150 Pa. 118, 24 Atl. 693; Chicago, etc., Ry. v. Kansas City N. W. R. R., 75 Kans. 167, 88 Pac. 1085; Erie, etc., R. R. v. Pennsylvania R. R., 208 Pa. 506. 57 Atl. 980; Clopton v. Phila. & Reading R. R. Co., 54 Pa. 356; Northern Central R. R. Co. v. Jackson, 7 Wall. 262; U. S. v. Baltimore & Ohio R. R. Co., 17 Wall. 322. See also article in Illinois Law Review, January, 1915.

CHAPTER 42

CONSTITUTIONALITY OF THE LAW

It is not the purpose of this chapter to discuss exhaustively the constitutional questions which might exist with respect to the present internal revenue laws, but to point out certain features of such laws with respect to which questions of constitutionality have been raised, and also to point out briefly a few general principles which may have a bearing upon the constitutionality of provisions of the Revenue Act of 1918. It is a long established principle vital to our constitutional system that a court is not authorized to adjudge a statute unconstitutional where the question as to its constitutionality is at all doubtful, and that unless the statute is plainly and palpably unconstitutional, it will be upheld. Instead of seeking for excuses for holding acts of the legislative power void by reason of their conflict with the constitution the effort should be made to reconcile them, if possible, and not to hold the laws invalid unless the opposition between the constitution and the laws be such that the court feels a clear and strong conviction of their incompatibility with each other.[1] Unless it be impossible to avoid it, a general revenue statute should never be declared inoperative in all its parts because a particular part, relating to a distinct subject, is invalid. It is an elementary principle that the same statute may be in part constitutional and in part unconstitutional, and that if the parts are wholly independent of each other that which is constitutional may stand and that which is unconstitutional will be rejected. It is only when different clauses of an act are so dependent upon each other that it is evident the Legislature would not have enacted one of them without the other—as when the two things provided are necessary parts of one system—that the whole Act will fall with the invalidity of one clause. When there is no such connection and de-

[1] Booth v. Illinois, 184 U. S. 431; Fletcher v. Peck, 6 Cranch 87; Brown v. Wallace, 161 U. S. 591; U. S. v. Delaware & H. Co., 213 U. S. 366.

pendency, the Act will stand, though different parts of it are rejected. A different rule might be disastrous to the financial operation of the government and produce the utmost confusion in the business of the entire country.[2] It will be noted that the Revenue Act of 1918 provides expressly that if any clause, sentence, paragraph or part shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair or invalidate the remainder of the act, but shall be confined in its operation to the clause, sentence, paragraph or part directly involved in the controversy in which the judgment is rendered.[3]

Construction of Constitutional Provisions. Constitutions are designed by their framers and accepted by the people as enduring instruments so comprehensive and general in their terms that a free, intelligent and moral body of citizens may govern themselves under their beneficent provisions through radical changes in social, economic and industrial conditions. They declare only fundamental principles as to the form of government and the mode in which it shall be exercised. Certain great powers are conferred and some limitations as to their exercise are established The amendments to a constitution together with the original constitution form one instrument which is to be interpreted in the light of the conditions under which its several parts were framed, the ends which it was designed to accomplish, the benefits which it was expected to confer, and the evils which it was hoped to remedy. It is a grant from the sovereign in the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to the constitution ought to be construed in the same spirit and according to the same rules as the original. It is to be interpreted as the constitution of the sovereign state and not as a statute or an ordinary piece of

[2] Field v. Clark, 143 U. S. 649; Rainey v. U. S., 232 U. S. 308; Underwood Typewriter Co. v. Chamberlain, (Conn.) 102 Atl. 600; State ex rel. Manitowoc Gas Co. v. Wis. Tax Commission, 161 Wis. 111; Robertson v. Pratt, 13 Haw. 590. In Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, the Court in pursuance of this rule discussed only the contentions in regard to the constitutionality of the Wisconsin Income Tax Law which might be considered as going to the validity of the whole act and declined to express any opinion as to the "minor provisions which are probably to be regarded as matters of detail."

[3] Revenue Act of 1918, § 1401.

legislation. Its words must be given a construction adapted to carry into effect its purposes.[4]

Power of Congress to Levy Income Taxes. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." As Chief Justice White has said,[5] this amendment does not confer power to levy income taxes in a generic sense or to limit and distinguish between one kind of income tax and another, but the whole purpose was to relieve all income taxes, when imposed, from apportionment; in short, doing away with the principle upon which the case[6] holding the 1894 Law unconstitutional was decided. The amendment places no limitation as to the nature and character of the income taxes which it authorizes. Congress derives from the Constitution[7] its powers "to lay and collect taxes, duties, imposts and excises." This power is exhaustive and embraces every conceivable power of taxation, limited only by the constitutional provisions that "all duties, imposts and excises shall be uniform, throughout the United States,"[8] that "direct taxes shall be apportioned among the several states"[9] and that "no capitation or other direct tax, shall be laid, unless in proportion to the census."[10] The Sixteenth Amendment removed the limitation of apportionment, but did not enlarge the power of Congress.

Taxing Gains and Profits from Sale of Property. The decision in Gray v. Darlington[11] has sometimes been mentioned as placing a limitation on the power of Congress to tax profits arising from the sale of capital assets, on the ground that the word "income" as used in the Sixteenth Amendment was used in the sense in which it had theretofore been defined in this case.[12] The

4 Trefry v. Putnam, (Mass.) 116 N. E. 904.

5 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

6 Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601.

7 Constitution of the United States, Art. 1, § 8.

8 Id. Art. 1, § 8, Cl. 1.

9 Id. Art. 1, § 2, Cl. 3.

10 Id. Art. 1, § 9, Cl. 4.

11 15 Wall. 63.

12 "* * * The word *income* must be presumed to have been used in the constitutional amendment (16th) in the sense in which the Supreme Court had theretofore defined it, if a judicial definition had been clearly given." Towne v. Eisner, 242 Fed. 702. In reversing this decision (245 U. S. 418) the

facts in Gray v. Darlington were that Darlington, who was apparently neither a merchant nor a trader, in 1865, being the owner of certain United States Treasury notes, exchanged them for United States bonds. Two years later the Income Tax Law of 1867 was enacted, and in 1869, two years after the incidence of the tax, he sold the bonds at an advance of $20,000 over the cost of the notes. Upon this amount was levied a tax of five per centum as gains, profits and income of the year 1869. Darlington paid the tax under protest and sued to recover, and prevailed. While the only question before the court was the extent to which Congress had intended by the Act of 1867 to tax gains, profits and income and the decision hinged on a consideration of the particular language of the 1867 Law, the court defined the term income more generally perhaps than was necessary. It is said in part: "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The *statute* looks, with some exceptions, for subjects of taxation only to *annual* gains, profits and income. Its general language is 'that there shall be levied, collected and paid annu-

Supreme Court expressed no disapproval of the statement quoted from the opinion of the lower court, and Judge Hand's remark seems to be a correct statement in general. Speaking of the word "income" in the Wisconsin constitutional amendment of 1911, the Court in State ex rel. Bundy v. Nygaard, 163 Wis. 307, 158 N. W. 87, said: "The word 'income' has a definite well-understood meaning. No attempt was made to define it in the constitutional amendment, for the reason that it carried its meaning with it." In Trefry v. Putnam, (Mass.) 116 N. E. 904, the Court said that the Federal Income Tax Law of 1913 might be presumed to have been more or less familiar to the members of the general court and the people during the discussion accompanying the adoption of the 44th amendment to the Massachusetts Constitution. This consideration among others moved the Court to decide that gains derived from the sale of personal property by one not engaged in the business of dealing in such property was taxable as income. See also Western Union Tel. Co. v. Julian, 169 Fed. 166.

ally upon the gains, profits and income of every person,' derived from certain specified sources a tax of five per cent, and that this tax shall be 'assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax.' [13] This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. There are exceptions, as already intimated, to the general rule of assessment thus prescribed. One of these exceptions is expressed in the statute, and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased, not only within the preceding year, but within the two previous years. Another exception is implied from the provision of the statute which requires all gains, profits, and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimation of the assessor. The estimation must, therefore, necessarily embrace gains and profits from trade and commerce, and these, for their successful prosecution, often require property to be held over a year. In the estimation of gains of any one year the trader and merchant will, in consequence, often be compelled to include the amount received upon goods sold over their cost which were purchased in a previous year. Indeed, in the estimation of the gains and profits of a trading or commercial business for any one year, the result of many transactions have generally to be taken into account which originated previously. Except, however, in these and similar cases, and in the cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected. The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified *by the statute.* It constitutes and can be

[13] 14 Stat. at Large, pp. 477, 478, § 13.

treated merely as increase of capital. The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the *statute*."[14] This decision has been referred to by the Supreme Court in recent cases, but its present force and effect is by no means clear. In one case,[15] arising under the 1909 Law, which imposed an excise tax measured by income, the Supreme Court referred to Gray v. Darlington as follows: "This court held that by the true construction of the Act, except as to gains and profits from trade and commerce and sales of real property, the statute only applied to such gains, profits and income as were strictly acquisitions made during the year preceding that in which the assessment was levied and collected. We do not regard the decision as controlling, because the language of the Act now under consideration is different in material particulars. As pointed out in Doyle, Collector v. Mitchell Brothers Co., this day decided, it imposes annually a special excise tax with respect to the carrying on or doing business by the corporation 'equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year,' to be ascertained by taking gross income and applying certain exceptions and deductions. 'Gains, profits, and income for the year ending the thirty-first day of December next preceding' (Act of 1867) conveys a different meaning from 'the entire net income * * * received by it * * * during such year' (Act of 1909). The former expression, as this court held (15 Wall. 65), denoted 'such gains or

14 The italicized words are italicized by the writer as possibly indicative of the point that the Supreme Court meant to confine the application of its statements to the particular statute being considered.

15 Hays v. Gauley Mountain Coal Co., 247 U. S. 189. See Scott v. Schwab, 255 Fed. 57.

profits as may be realized from a business transaction begun and completed during the preceding year,' with the exceptions already mentioned. The expression 'income received during such year,' employed in the Act of 1909, looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (January 1, 1909), excludes income that accrued before that date. There are other differences upon which we need not dwell.'' In a case [16] arising under the 1913 Law the court, after quoting part of the opinion in Gray v. Darlington and stating that the case has not since

[16] Lynch v. Turrish, 247 U. S. 221. It does not seem that this consideration of the effect of Gray v. Darlington was strictly necessary to the decision in Lynch v. Turrish, as the Supreme Court might well have rested its decision on the first point relied on by Judge Sanborn in the Circuit Court of Appeals and on which point it completely vindicated that court, but the statement can scarcely be called dicta. In the case of Cleveland, C., C. and St. L. Ry. Co. v. U. S., 242 Fed. 18, affirmed 247 U. S. 195, the Circuit Court of Appeals said: ''The precise point decided in Gray v. Darlington was that the accretion in value during the previous years was not income for the year in which the property was sold; but doubtless some of the language of the opinion would indicate that such accretions were not income even for the year in which they happened.'' In a case arising under the 1909 Law (Doyle v. Mitchell Brothers, 247 U. S. 179) Judge Pitney, who delivered the opinion quoted above from Hays. v. Gauley Mountain Coal Co., said: ''When we come to apply the Act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the Act, questions of difficulty are encountered. The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the Act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.' * * * The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the Act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the Act, and brings the former into incongruity with the latter. * * * Yet it is plain, we think, that by the true intent and meaning of the Act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities.''

been questioned or modified said in part: "The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that act from the Act of 1913 and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the Act of 1867 makes the income one 'derived.' Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of Gray v. Darlington, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore, as 'arising or accruing,' to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income." Aside from the differences in the language of the Act of 1867 and the Revenue Act of 1918, the latter contains a provision expressly prescribing the method of computing the gain derived from the sale of assets acquired before March 1, 1913. It was intimated in Gray v. Darlington that the rule as to merchants and traders would be different from the rule as to persons making isolated investments,[17] this difference being due to the language of the

[17] In Trefry v. Putnam, (Mass.) 116 N. E. 904, the Court refused to consider any distinction between merchants and traders and persons making isolated investments; it said: "It hardly can be thought that the people, in distinction between incomes derived from a business of buying and selling property, on the one side, and the profits realized by one not engaged in such business, but occasionally and casually, and not as a business, making purchases and sales, on the other side, and to grant to their representatives authority to tax the one and to deny them authority to tax the oher." The Court thereupon answered the question "Are excesses or gains over losses in the purchase and sales of intangible personal property by one not engaged conferring the power to tax incomes, intended to perpetuate for all time a

act and predicated upon the general principle that merchants and traders have generally to take into account transactions originating in prior years in order to estimate their gains in any one year. There seems to be no doubt that Congress intended under the Revenue Act of 1918 to tax profits from sales of property acquired prior to the taxable year, and the law makes no distinction between the investor and the merchant or trader.[18] It is to be noted, however, that the 1918 Law imposes a tax "upon the net income of every individual" and "upon the net income of every corporation;" that gross income is defined to include "gains, profits and income *derived* from" specified sources, thus following to some extent the language of the income tax law of 1867, and that it does not tax "income received," which phrase in the 1909 Law led Mr. Justice Pitney to remark that that law "looked to the time of realization rather than to the period of accruement" of the income. Whether the 1918 Law intends to tax so-called "gains from the sale of capital assets" and whether the gradual increase in value of property over a series of years can be taxed under the Sixteenth Amendment are unsettled questions.

Requiring Disclosure of Interest on State and Municipal Obligations. Although the Revenue Act of 1918 expressly exempts from taxation interest upon the obligations of a state or any

in the business of dealing in such property tangible as income," in the affirmative.

18 Under the English Income Tax Act of 1853 (16 and 17 Vict. chap. 34, schedule D), which imposes a tax on profits and gains derived from carrying on a trade or business, it has been held that the sale price of land is not taxable where the sale is not part of a business of selling land, but is merely a sale by a private owner. (Stevens v. Hudson's Bay Co., (1909) 101 L. T. N. S. (Eng.) 96, 25 T. L. R. 709; Tebrau Rubber Syndicate v. Farmer, (1910) S. C. 906, 47 Scot. L. R. 816). Where the sales constitute a part of the business of the seller, the English rule is that profits realized within the year for which a tax thereon is levied are taxable. In Tax Comr's v. Melbourne Trust, (1914) A. C. (Eng.) 1001, 84 L. J. P. C. N. S. 21, 111 L. T. N. S. 1040, 30 T. L. R. 685, in construing and applying State of Victoria (Australia) Income Tax Act of 1903, it was held that a trading company organized for the purpose of dealing in assets of other companies and disposing of such assets at a profit, received income taxable under the act, the purpose of which was to make the profits of trading companies assessable to income tax. California Copper Syndicate v. Harris, (1904; Scot. Ct. of Sess.) 6 F. 894, 41 Scot. L. R. 691.

political subdivision thereof, presumably because a *tax* on such interest would be unconstitutional, it requires any person owning such obligations to submit a statement showing the number and amount thereof and the income received therefrom, in such manner and form and with such information as the Commissioner shall require.[19] It has been asserted that this provision is unconstitutional in that it imposes the burden upon state and municipal obligations of compelling the owner to make a computation and disclosure of his income therefrom,—a burden which, if admitted in principle, could be stretched to such an extent that the owner would prefer to pay the tax in order to escape the greater burden of supplying the Government with a mass of detail in regard to his ownership of such securities. Congress seems to have no general power to make inquiry into the affairs of a citizen or to investigate the affairs of citizens as a mere matter of private concern or governmental curiosity,[20] and an individual may refuse to answer an unauthorized inquiry.[21] Regarding the question from the standpoint of individual liberty and privacy or from the standpoint of authority in a particular case to make inquiry and compel answer, it is difficult to see in the above inquiry introduced by the Revenue Act of 1918 as to state and municipal obligations any legitimate purpose connected with the raising of revenue or any other function of the federal government. It does not seem that taxpayers should be obliged to speculate as to a possible undisclosed purpose on the part of Congress which might render the provision authorized and proper.

Want of Due Process of Law. The due process clause of the Fifth Amendment to the Federal Constitution is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, the Constitution is not self-destructive and does not conflict with itself by conferring on the one hand a taxing power and taking the same away on the other by the limitations of the due process clause. To make a tax statute unconstitutional the seeming exercise of the taxing power of the act must be

19 Revenue Act of 1918, § 213 (a) 4.

20 See Interstate Commerce Comm'n v. Brimson, 154 U. S. 447, 478; In re Chapman, 166 U. S. 661, 668; Kilbourn v. Thompson, 103 U. S. 168; Harriman v. Interstate Commerce Comm'n, 211 U. S. 407; In re Pacific Ry. Comm'n, 32 Fed. 241.

21 Boyd v. U. S., 116 U. S. 616.

so arbitrary as to constrain to the conclusion that it is not the exertion of taxation, but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, is so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.[22] In a late case arising under the 1913 Law[23] the Supreme Court enumerated a number of features of the 1913 Law which, it had been alleged, constituted a violation of the due process clause, and dismissed them with the statement that none in the remotest degree presented such questions. Among such objections were the following: (1) that the progressive rate and exemption features of the law were based on wealth alone and were wanting in due process of law,[24] (2) that the duty cast upon corporations of collecting the tax at the source was wanting in due process of law, (a) because of the cost to which they were subjected, (b) because of the resulting discrimination between corporations indebted upon coupon and registered bonds and corporations not so indebted, (c) because of the further discrimination in the case of corporations so indebted which had assumed the payment of taxes on their bonds, (d) because of the further discrimination against corporate bondholders in the deprivation of the use of their money between the deduction and payment of the tax withheld, (e) because of the further discrimination against corporate bondholders in the fact that they might be obliged to pay the tax a second time if the corporation should fail after deduction, and (f) because of a further discrimination against bondholders in that they were not relieved of the duty of reporting bond income by payment at the source, the result being a double payment of the tax, labor and expense in obtaining a re-

22 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

23 Id.

24 Speaking of the progressive feature of the Wisconsin Income Tax Law the Wisconsin Court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "With regard to the progressive feature, it is aptly said in Knowlton v. Moore, 178 U. S. 41, at p. 109, 20 Sup. Ct. 747, by the present chief justice, that 'taxes imposed with reference to ability of the person upon whom the burden is placed to bear the same have been levied from the foundation of the government. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is legislative and not judicial.' "

fund and deprivation of the use of their money in the meantime; (3) that the limitation on the amount of interest deductible by corporations is wanting in due process; (4) that the privilege granted to individuals of deducting dividends for purposes of normal tax was a discrimination against corporations;[25] (5) that the deduction of $3,000 or $4,000 to those who pay the normal tax and not to those with incomes over $20,000 was wanting in due process;[26] (6) that the discrimination between married and single people and between husbands and wives living together and husbands and wives not living together was wanting in due process;[27] (7) that the law involved a discrimination and want of due process in favor of house owners living in their own

[25] In holding that the application of a different rate in the case of corporations and individuals was permissible, the Wisconsin Court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "The corporate privileges, which are exclusively held by corporations, and the real differences between the situation of a corporation and an individual, among which may be mentioned the fact that the corporation never is obliged to pay an inheritance tax, plainly justify a difference of treatment in the levying of the income tax. Were the income tax a tax upon property, there could be no difference in rate, for taxation of property must still be on a uniform rule, but, as has been heretofore noted, it is not a tax upon property within the meaning of our constitution."

[26] In Campbell v. Shaw, 11 Haw. 112, it was held that the Hawaiian Income Tax Act of 1896 was unconstitutional by reason of the fact that it allowed an exemption of $2000 on incomes under $4000, whereas no such exemption was allowed on incomes over $4000. In Robertson v. Pratt, 13 Haw. 590, it was decided that an exemption of incomes to the amount of $1000 was not invalid on the ground that it was excessive. See also Peacock v. Pratt, 121 Fed. 772; In re Income Tax Act, 10 Haw. 317.

[27] With regard to the provision of the Wisconsin Income Tax Law that the income of a wife living with her husband shall be added to the income of the husband, the Wisconsin Court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "This is another case of classification, and it is only justifiable in case there is some substantial difference of situation which suggests the advisability of difference of treatment. We think there clearly is such a difference, in this, that experience has demonstrated that otherwise there will be many opportunities for fraud and evasion of the law, which the close relationship of husband and wife or parent and child makes possible, if not easy. The temptation to make colorable shifts and transfers of property in order to secure double or even triple exemptions, if there were not some provision of this kind in the law, would unquestionably be very great. There is no such temptation or opportunity in the case of the single man, or the man and wife who are living separately."

houses who were not compelled to estimate the rental value against those who paid rent and were not allowed to deduct it and in favor of farmers who might deduct products of the farm used by them in sustaining their families whereas family expenses might not, as a rule, be deducted. In another case [28] it was held there exists a substantial difference between the carrying on of business by corporations and the same business by a private firm or individual, and the 1909 Law was, therefore, not unconstitutional on the ground of arbitrary discrimination. In another case the court held that the fact that the tax was levied on the income of mining companies without making adequate allowance for depletion did not amount to the taking of property without due process of law.[29] In a case [30] arising under the law taxing foreign-built yachts it was stated by the court that the distinction between things foreign and things domestic, and their use, was apparent on the face of things and to tax them separately was not an arbitrary discrimination.

Uniformity. The Constitution exacts only a geographical uniformity of taxes and a lack of uniformity in other respects does not make the statute invalid.[31]

Exempting Certain Corporations from Tax. The provision of the Sixteenth Amendment authorizing a tax on incomes "from whatever source derived" does not require that the tax must be imposed upon all sources of income nor does it exclude the power to exempt certain classes of corporations.[32]

Retroactive Features. The right of Congress to impose a tax by a new statute, although the measure of the tax is governed by the income of the past year cannot be doubted; much less can it be doubted that Congress may impose a tax on income of the current year, though part of that year has elapsed when the statute is passed.[33] A statute imposing a tax upon all income of a pre-

28 Flint v. Stone-Tracy Co., 220 U. S. 107.

29 Stanton v. Baltic Mining Co., 240 U. S. 103.

30 Billings v. U. S., 232 U. S. 261.

31 Knowlton v. Moore, 178 U. S. 41; Patton v. Brady, 184 U. S. 608; Flint v. Stone-Tracy Co., 220 U. S. 107; Billings v. U. S., 232 U. S. 261; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

32 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

33 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Billings v. U. S., 232 U. S. 261. With regard to the retroactive feature of the Wisconsin Income

vious year, although one tax on that income has already been paid, is valid.[34]

Tax Law the Wisconsin Court in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, overruled objection "without comment, for the reason that it seems very unsubstantial."

[34] Stockdale v. Insurance Companies, 20 Wall. 323.

CHAPTER 43

WAR-PROFITS AND EXCESS-PROFITS TAX

The Act of March 3, 1917, was the first excess-profits tax law enacted in this country.[1] It applied only to corporations and partnerships and imposed a tax of 8% on all net income in excess of the sum of $5,000 plus 8% of the actual capital invested.[2] A small amount of tax was collected under this statute from corporations whose fiscal years ended in the succeeding months but any amounts so collected were credited or refunded to the taxpayers. The next law, enacted October 3, 1917, imposed a tax on the net income of individuals, partnerships and corporations, derived from any business or trade. This latter statute (referred to in this Chapter as the 1917 Law) was retroactive to January 1, 1917, and covered the period during which the Act of March 3, 1917, had been in effect. The rates of the 1917 Law as applied to corporations having invested capital were 20% of that part of the net income which exceeded the excess-profits deduction and did not exceed 15% of the invested capital; 25% on that part of the net income which exceeded 15% of the invested capital and did not exceed 20% of the invested capital; 35% of the net income which exceeded 20% of the invested capital and did not exceed 25% of the invested capital; 45% on that part of the net income which exceeded 25% of the invested capital and did not exceed 33% of the invested capital; and 60% on that part of the net income which exceeded 33% of the invested capital.[3] In the case of a trade or business which had no invested capital or not more than a nominal capital, the excess-profits tax was 8% on the entire net income in excess of $3,000 in the case of a domestic

1 39 Stats. at Large 1000.

2 The statute defined the term "actual capital invested" to mean (1) actual cash paid in; (2) the actual cash value at the time of payment of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business; but to exclude money or other property borrowed.

3 Revenue Act of 1917, § 201.

corporation and $6,000 in the case of a domestic partnership, or a citizen or resident of the United States. In the case of a foreign corporation or partnership or a non-resident alien this rate was imposed upon the entire net income without deduction.[4] The Act of February 24, 1919, (referred to in this chapter as the Revenue Act of 1918, the 1918 Law, or the present law) imposed a tax on income received during the year 1918 in lieu of the tax imposed by the 1917 Law. In view of the increased individual normal and surtax rates upon the income of individuals and partnerships, which in most cases make the income taxes paid by such individuals as high as the income and excess-profits or war-profits taxes paid by corporations engaged in similar business, and in view of the difficulty in administering an excess-profits tax applicable to individuals, it was decided by Congress that the war- and excess-profits taxes should apply to corporations only.[5] It was also recognized that there exists a class of corporations which require very little or no invested capital and whose income is derived mainly from the personal services of the stockholders. Examples of such corporations are corporations composed of engineers or accountants, who might as readily have formed partnerships to carry on their business. Such corporations are called "personal service corporations" and are treated as though they were partnerships. No excess-profits tax is imposed upon their net income but the stockholders of the personal service corporation are taxable upon the entire net income of the year, whether or not such income is distributed in the form of dividends. The tax imposed by the present law combines two general principles of taxation: (a) that of a war-profits tax, which is usually considered to be a tax on the excess of profits made during the years of the war period over the normal profits of the years prior to the war and (b) an excess-profits tax, which is considered as a tax upon the profits in excess of a specified percentage representing an approximate normal return on the invested capital. The law, however, does not adhere to a clear distinction between war-profits and excess-profits since the war-profits tax combines a feature of the excess-profits tax in that a

[4] Revenue Act of 1917, § 209.

[5] Report of the Committee on Ways and Means on the Revenue Bill of 1918, September 3, 1918.

minimum deduction of 10% of the invested capital is allowed regardless of the earnings of the corporation during the prewar period. Under the excess-profits method of computing the tax the rate for 1918 was 30% of that part of the net income which exceeded the excess-profits deduction and did not exceed 20% of the invested capital and 65% of that part of the income which exceeded 20% of the invested capital. The war-profits tax rate is a single rate of 80% in excess of the war-profits credit.[6] This combination of principles applied generally, however, only to income of the year 1918. For subsequent years the war-profits tax is discarded and the excess-profits tax alone imposed, except as to income received from government contracts, as more fully stated in a following paragraph. The rate of the excess-profits tax for the taxable year 1919 (and subsequent years until the law is changed) is 20% on that part of the net income which exceeds the excess-profits credit and does not exceed 20% of the invested capital, and 40% on the remaining net income.[7]

Individuals. Individuals are not subject to the excess-profits tax. Since individuals were not allowed to file returns on the basis of their fiscal years under the 1917 Law,[8] no individual has paid a tax on 1918 income under the 1917 Law, and, therefore, the 1918 Law contains no provision with respect to individuals such as the provision[9] with respect to partnerships for redetermining the tax due on 1917 income.

Partnerships. Partnerships are not subject to the excess-profits tax under the present law.

PARTNERSHIPS WHICH PAID A TAX ON 1918 INCOME. If a partnership made a return under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, and paid the tax, a certain proportion thereof will be refunded. This amount is to be deter-

6 Revenue Act of 1918, § 301 (a). It has been estimated that under the 1917 Law, the average amount of excess-profits tax was about 30% of the net income of taxable corporations for the year 1917. It has been conjectured that the war-profits and excess-profits taxes absorbed on an average about 45% of the 1918 income. In addition the income tax absorbed 12% of the remainder so that probably about one-half of the net income of corporations for the year 1918 was paid to the Federal Government by way of war-profits, excess-profits and income taxes.

7 Revenue Act of 1918, § 301 (b).

8 See p. 156.

9 Revenue Act of 1918, § 335 (c).

mined by taking the same proportion of the tax so paid which the proportion of the fiscal year falling in 1917 was to the entire fiscal year. Thus, if one-fourth of the fiscal year fell in 1917 and three-fourths in 1918, three-fourths of the tax which has been paid will be refunded immediately as a tax erroneously or illegally collected.[10]

Personal Service Corporations. Personal service corporations are not subject to the excess-profits tax, but are taxed as partnerships.[11] Such corporations are described in a preceding chapter.[12]

PERSONAL SERVICE CORPORATIONS WHICH PAID A TAX ON 1918 INCOME. If any corporation which under the present law is held to be a personal service corporation has filed a return and paid a tax under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, a portion of the tax so paid will be refunded. The amount to be refunded is determined by the proportion of the fiscal year falling in 1918 to the entire fiscal year. Thus, if five months of the fiscal year fell in the calendar year 1918, five-twelfths of the tax paid on the income of the full fiscal year will be refunded.[13] If the tax has been paid claim for refund should be filed.[14]

Corporations Engaged Partly in Personal Service Business. Where a part of the net income of a corporation is derived (1) from a trade or business (or a branch thereof) in which the em-

10 Revenue Act of 1918, § 335 (c). See Chapter 37 for procedure in claiming refund or abatement.

11 Revenue Act of 1918, §§ 300 and 200.

12 Chapter 11. The 1917 Law imposed a tax of 8% upon a trade or business having no invested capital or not more than a nominal capital. (Revenue Act of 1917, § 209.) This provision is omitted from the present law but in its place are the provisions respecting personal service corporations. Under the 1917 Law it was held that business concerns which rendered professional or personal services would not be taxed on the basis of invested capital merely because of the capital if the employment of such capital was necessitated by delay and irregularity in the receipt of fees, etc., or if such capital was wholly or mainly used as a fund from which to advance salaries, wages, etc., or provide office furniture, accommodations and equipment. Agents and brokers were held to be taxable at the graduated rates with reference to invested capital if they employed a substantial amount of capital whether to lend to principals or to carry goods on their own account but otherwise were taxable only at the flat rate of 8%. (Reg. 41, Arts. 72 and 73.)

13 Revenue Act of 1918, § 335 (c).

14 See Chapter 37 for procedure as to refund.

ployment of capital is necessary and (2) a part (constituting not less than 30% of its total net income) is derived from a separate trade or business which, if it constituted the sole trade or business, would bring the corporation within the class of personal service corporations, the tax upon that part of the net income which is derived from the use of capital is separately computed (allowing in such computation only the same proportionate part of the war-profits and excess-profits credits) and the tax upon the second part of the net income is the same percentage thereof as the tax computed upon the first part of the net income is of such first part.[15]

APPORTIONMENT OF INVESTED CAPITAL AND NET INCOME. For the purpose of determining whether or not a corporation partly partaking of the nature of a personal service corporation is within the scope of the statute and also for the purpose of establishing the basis for the computation of the tax, the corporation is required to apportion or allocate its invested capital between each trade or business or branch thereof as nearly as may be in accordance with the actual facts, and to submit with its return an explanatory statement setting forth the manner in which the apportionment of the invested capital employed in the production of each part of its net income has been determined. There must be assigned to any personal service trade or business or branch thereof an amount of invested capital at least as great as that which would ordinarily be employed by a personal service corporation of similar size and standing for the payment of salaries and office expenses, maintenance of library and equipment, credit advances to clients, etc.[16]

COMPUTATION OF TAX UPON NET INCOME. (1) The tax upon the non-personal service part of the net income is computed upon the basis of (a) such part of the entire average net income for the prewar period as was derived from the same trade or business or branch thereof; (b) such part of the entire average invested capital for the prewar period as was employed in the production of the part of the net income for that period determined under (a); (c) such part of the entire invested capital for the taxable year as has been employed in the production of the net income

[15] Revenue Act of 1918, § 303.

[16] Reg. 45, Art. 741. For the method of determining the portion of the net income from each trade or business or branch thereof see p. 650.

upon which the tax is being computed; and (d) the same proportion of the specific exemption and credits as the proportion which the part of the net income upon which the tax is being computed is of the entire net income. If the corporation was in existence during the prewar period, but did not conduct this trade or business or branch thereof during that period, the war-profits credit is 10% of the invested capital for the taxable year. (2) The tax upon the personal service part of the net income is the same percentage thereof as the tax computed under (1) is of the non-personal service part of the net income. The tax under this paragraph may in no case be less than 20 per cent of the personal service part of the entire net income, unless the tax upon the entire net income if computed in the ordinary way would be less than 20 per cent of such entire net income. In that event, and in any case in which the amount of the total tax as computed above is the same as or greater than the tax as computed in the ordinary way, the tax must be computed as if all the income was derived from the use of capital.[17]

Corporations. All corporations except those expressly exempt by the statute are subject to the excess-profits tax. The term "corporations" includes associations, joint-stock companies and insurance companies.[18] A corporation dissolved prior to February 25, 1919, when the present law went into effect, but which was in receipt of income after January 1, 1918, will be held subject to the tax imposed by the present law for the reason that the law is retroactive to the first day of January, 1918.[19]

EXEMPT CORPORATIONS. Corporations exempt from the income tax are also exempt for the purpose of the excess-profits tax.[20] In addition, any corporation whose net income for the full taxable year of twelve months is less than $3,000 is exempt from this tax. If the taxable period is less than twelve months the corporation is exempt from the tax if its net income for the period is less than the same proportion of $3,000 as the number of months in the period is of twelve months, any fractional part of a month

17 Reg. 45, Art. 742. See illustration No. 5, Appendix.

18 See Chapter 10 for discussion of the definition of the term "corporations."

19 See letter from Treasury Department dated November 17, 1917; W. T. S. 1919, ¶ 757.

20 Revenue Act of 1918, § 304 (a). See Chapter 13 for list of exempt corporations under the income tax law.

being counted as the number of days in such part of a month divided by 30.[21]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. Special provisions apply to corporations deriving income from government contracts. A government contract is defined in the law to be (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a sub-contract made with a contractor performing such a contract if the products or services to be furnished under the sub-contract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive," when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[22] For the taxable year 1919 and thereafter every corporation which derives in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be required to pay the tax at the 1918 rates on the net income attributable to such government contracts, such tax to be computed according to the rule stated in a subsequent paragraph.[23] Corporations which have no prewar period and which were in receipt of 50% or more of gross income during the taxable year from gains, profits, commissions or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be limited to a war-profits credit of 10% on the invested capital of the taxable year,[24] although other corporations (other than corporations a majority of whose stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the

[21] Revenue Act of 1918, § 304 (b); Reg. 45, Art. 751.

[22] Revenue Act of 1918, § 1.

[23] Revenue Act of 1918, § 301 (c). See p. 650 and illustration No. 4, Appendix.

[24] Revenue Act of 1918, § 311 (d).

whole of at least one calendar year during the prewar period) which had no prewar period may claim a higher deduction if the earnings of similar corporations during the prewar period were more than 10%. Corporations 50% or more of whose gross income for the taxable year consists of gains, profits, commissions or other income derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will not be allowed to avail themselves of the remedial provision which will permit other corporations to be assessed on the basis of the tax paid by representative corporations.[25] It is to be noted that the first two provisions refer to government contracts generally while the third provision is limited to cost-plus contracts. A corporation organized after August 1, 1914, and not a successor to a then existing business, 50% or more of whose gross income consists of gains, profits, commissions or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, cannot be considered as affiliated with any other corporation for the purpose of making consolidated returns.[26]

GOLD-MINING CORPORATIONS. In the case of a corporation engaged in the mining of gold, that portion of its net income derived from the mining of gold is exempt from excess-profits tax. The tax on the remaining portion of its net income is computed in the following manner: The tax is first computed on the entire net income but only such proportion thereof as the proportion of net income derived from sources other than gold mining bears to the entire net income, is taken to be the amount due.[27]

Allocation of Net Income to Particular Source. In the case of corporations deriving income from government contracts, or from mining or from personal service trade or business, and in any other cases where it is necessary to determine the portion of the net income derived from or attributable to a particular source, the corporation is required to allocate to the gross income derived from such source, and to the gross income derived from each other source, the expenses, losses and other deductions properly appertaining thereto, and to apply any general expenses, losses and de-

[25] Revenue Act of 1918, § 327 (d). See p. 699.
[26] Revenue Act of 1918, § 240 (a). See p. 708.
[27] Revenue Act of 1918, § 304. See illustration No. 6, Appendix.

ductions (which can not properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from a particular source, less the deductions properly appertaining thereto and less its proportion of any general deductions, is the net income derived from such source. The corporation must submit with its return a statement fully explaining the manner in which such expenses, losses and deductions were allocated or distributed.[28]

Taxable Year. The term "taxable year" means the calendar year or the fiscal year ending during such calendar year, upon the basis of which net income is computed for the purpose of the income tax. The first taxable year under the Revenue Act of 1918 is the calendar year 1918 or any fiscal year ending during the calendar year 1918.[29]

Fiscal Year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.[30] If a corporation keeps its accounts on the basis of a fiscal year, the law requires that it report its income on that basis, and not at its option either on that basis or on the basis of the calendar year as was the rule formerly.[31]

Prewar Period. The term "prewar period" means the calendar years 1911, 1912 and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence. Thus, if a corporation was in existence during the entire year 1913, that year becomes its prewar period, but if in existence only a part of the year 1913 it is deemed to have no prewar period and becomes taxable under the provisions applying to corporations formed after the prewar period.[32]

28 Reg. 45, Art. 715.

29 Revenue Act of 1918, §§ 300 and 200.

30 Revenue Act of 1918, § 300 and § 200.

31 Revenue Act of 1918, § 232, § 212 (b) and § 200.

32 Revenue Act of 1918, § 310. Under the 1917 Law the earnings of the prewar period determined the amount of the excess-profits deduction, between the limits of 7% and 9% of the invested capital. Under the present law no reference is made to the prewar period in ascertaining the excess-profits credit, since that credit is 8% of the invested capital regardless of the prewar earnings. But the prewar earnings and prewar invested capital are used in computing the war-profits credit under the Revenue Act of 1918.

Statement of the Tax. The tax imposed by Title III of the Revenue Act of 1918, is in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by the Revenue Act of 1918. The tax is imposed upon the net income of every corporation,[33] whether or not derived from a business or trade or from investment or otherwise.[34] Briefly stated, the excess-profits tax is computed on the entire net income of the taxable year after deducting the excess-profits credit, at the rates specified in the statute. For the taxable year 1918 the war-profits tax was computed on the entire net income in excess of the war-profits credit at the rate specified in the Act, and whichever of the two taxes (the excess-profits or war-profits) was the greater was assessed. The rates of tax, net income, invested capital, excess-profits credit and war-profits credit are more fully discussed in the following paragraphs.

Rates of Tax for 1918. The rates of tax are stated in the form of three brackets as follows:[35] First bracket, 30% of the amount of net income in excess of the excess-profits credit and not in excess of 20% of the invested capital. If the excess-profits credit equaled or exceeded 20% of the invested capital, no tax was imposed under this bracket. The second bracket provided a rate of 65% of the amount of net income in excess of 20% of the invested capital. If, however, the excess profits credit exceeded 20% of the invested capital, this rate was applied only to the amount of net income in excess of such excess-profits credit.[36] The third bracket provided that there should be added to the tax computed under the first and second brackets the sum, if any, by which 80% of the amount of net income in excess of the *war-profits credit* exceeded the amount of tax computed under the first and second brackets. As a practical matter, if 80% of the amount of net income in excess of the war-profits credit was greater than the tax computed under the first and second brackets, the 80% tax became the tax due from the corporation and the computation under the first and second brackets might be disregarded.[37]

[33] Revenue Act of 1918, § 301.

[34] See Revenue Act of 1918, §§ 213 (a), 233 (a).

[35] Revenue Act of 1918, § 301 (a).

[36] Revenue Act of 1918, § 301 (d). See illustration No. 2, Appendix.

[37] This device of adding the excess amount of the war-profits tax over the excess-profits tax to such excess-profits tax was invented by the Senate to

Rates of Tax for 1919 and Subsequent Years. In the case of all corporations other than those referred to in the following paragraphs, the rates for 1919 and subsequent years computed under the first bracket as above indicated are 20% instead of 30% and under the second bracket are 40% instead of 65%. No tax is imposed under the third bracket.[38]

Fiscal Year Ending in 1919. If a corporation makes a return for a fiscal year beginning in 1918 and ending in 1919 the tax for such fiscal year is determined as follows: The amount of tax for the entire fiscal year computed at the 1918 rates is first determined and such proportion thereof as the part of the fiscal year falling in 1918 bears to the entire fiscal year is assessed as a portion of the tax. Similarly the 1919 rates are applied to the entire net income for the fiscal year and such portion assessed as the proportion of the fiscal year in 1919 bears to the full fiscal year.[39] The sum of the two portions thus ascertained is the tax for the fiscal year.

Corporations Deriving Income from Government Contracts. For the taxable year 1919, and each taxable year thereafter, the rates to be applied to corporations which derive in such year a

overcome the objection to the provision in the bill as originally drafted, which expressly provided for an alternative excess-profits or war-profits tax, the larger of the two being the amount assessed. The change made by the Senate did not in substance change the tax and it was still a tax computed by two alternative methods, the one productive of the greater amount of revenue being applied to the taxpayer.

38 Revenue Act of 1918, § 301 (b). See illustration No. 1, Appendix.

39 Revenue Act of 1918, § 335 (b); illustration No. 8, Appendix. The same principles governed the computation of the tax for a corporation with a fiscal year beginning in 1917 and ending in 1918. (Revenue Act of 1918, § 335.) Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by the Revenue Act of 1917, is to be credited toward the payment of the tax so computed, and if the amount so paid exceeds the amount of tax so computed the excess is to be credited or refunded to the corporation. Corporations whose fiscal years ended in 1918, may have filed a return and paid the tax for the full fiscal year under the provisions of the Revenue Act of 1917. In such case the tax is to be recomputed in the manner indicated and from the amount so found to be due should be deducted the amount of excess-profits tax heretofore paid on the basis of the full fiscal year. It follows that the income tax for the same period must also be recomputed according to the rule in § 205 (a) of the 1918 Law after having deducted the excess-profits taxes as recomputed.

net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, are determined as follows: (1) the tax will be computed at the 1918 rates on the entire net income of the corporation, in the computation of which the excess-profits credit and war-profits credit applicable to the taxable year will be used, and (2) the tax will also be computed on the entire net income of the taxable year at the 1919 rates. The sum of (a) such portion of the tax computed under (1) as the net income attributable to such government contract or contracts bears to the entire net income and (b) such portion of the tax computed under (2) as the part of net income not attributable to such government contract or contracts bears to the entire income will be the amount to be paid by the corporation.[40] The method of computing the tax is illustrated below.[41]

Maximum Limit of Tax. The Revenue Act of 1918 for the first time fixes a maximum limit of tax. In no case will the tax imposed on the net income for the taxable year 1919 or subsequent years, be more than 20% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 40% of the amount of net income in excess of $20,000. On income of the year 1918 the maximum was 30% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 80% of the amount of net income in excess of $20,000. In the case of corporations deriving more than $10,000 of net income from government contracts in 1919 or subsequent years, these limits will apply to the respective amounts of tax computed under the 1918 and 1919 rates, by reason of the provision taxing 1919 income from government contracts at 1918 rates. Thus, on that part of the net income derived from government contracts the maximum limit of 30% and 80% will apply while to that not derived from government contracts the maximum limit of 20% and 40% will apply. This limit is not intended to increase the tax but to reduce it in cases where the tax calculated in the ordinary manner is greater than the maximum computed according to the rule stated

40 Revenue Act of 1918, § 301 (c). See p. 650 for rule as to allocation of income.

41 See illustration No. 4, Appendix.

in this paragraph.[42] The limitation will generally operate only in the case of corporations with very small invested capital.[43]

SALE OF MINES, OIL OR GAS WELLS. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the war-profits and excess-profits tax attributable to such sale cannot exceed 20% of the selling price of such property or interest.[44] To apply this provision to a particular case the corporation should compute the war-profits and excess-profits taxes in the ordinary way upon its net income, including its net income from any such sale. The proportion of the total tax indicated by the ratio which the taxpayer's net income from the sale of the property, allocated to such source by the proper method,[45] bears to its total net income is the portion of the tax attributable to such sale, and if it exceeds 20% of the selling price of the property, such portion of the tax will be reduced to 20% of such selling price.[46]

Invested Capital.[47] "Invested capital" is the value of the capital and surplus of the taxpayer determined in accordance with rules laid down in the statute. It does not mean the par value of the issued and outstanding stock or the value of the capital stock as fixed by the Treasury Department for the purpose of the capital stock tax. It does not mean the book value of the assets, or the present net worth of the assets as shown by an appraisal or in any other manner.[48] Generally speaking, it means the amount of cash or the cash value of the property contributed to the corporation by the stockholders and

[42] Revenue Act of 1918, § 302. See illustration No. 10, Appendix.

[43] An invested capital of less than $71,428.58.

[44] Revenue Act of 1918, § 337.

[45] See Reg. 45, Art. 715. See p. 650.

[46] Reg. 45, Art. 971. See illustration No. 7, Appendix. It will be noted that the Government ruling requires the total tax to be apportioned for the purpose of applying the limitation. The statute provides that the "portion" of the tax attributable to such sale shall not exceed 20% of the selling price, and the difference between the amount of tax computed on the total income and the amount computed on the income excluding the profit on the sale seems intended by the law to be the amount which shall not exceed 20% of the selling price.

[47] As to affiliated corporations see p. 708.

[48] Reg. 45, Art. 831.

the amount of earnings of the corporation which have been left in the business. Money or other property borrowed is not invested capital.[49] The cash value of the property contributed by the stockholders to the corporation may in some cases exceed the value allowed by the law for purposes of invested capital, since the restrictive rules of the statute limit the inclusion in invested capital of capital stock representing intangible property. Further, capital may be contributed to the business of a corporation in a form originally permitting its inclusion in invested capital at its full value (cash, for instance) but may lose some of its value for purposes of invested capital by being invested in stocks of other corporations (the dividends of which are not included in net income) [50] or by being invested in state, municipal or other bonds, the interest on which is exempt from income tax. In this respect the law makes an exception of bonds or other obligations of the United States, which may be included in invested capital although the interest therefrom may in some cases be excluded from gross income.[51] Surplus and undivided profits are recognized as part of invested capital, if they represent assets actually existing and owned by the corporation. The surplus and undivided profits accounts may be reduced below the amounts at which they are carried on the books, if full recognition has not been given by the corporation to expenses incurred and losses sustained from the original organization down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation or obsolescence of property originally acquired for cash or stock, or in any other manner. The value of the assets of the company are required in all instances to be taken as of the time of acquisition, although they may have increased in value since that date. The fair market value of the assets as of March 1, 1913, has no bearing on invested capital.[52] If values have been marked up on the books of the corporation a deduction must be made in respect of such book appreciation. Full effect must

49 Reg. 45, Art. 831.

50 Reg. 45, Art. 815.

51 The purpose of permitting bonds of the United States to be included in invested capital, although the interest may be excluded in whole or in part from gross income, is to provide an incentive to invest in and hold such bonds.

52 Reg. 45, Art. 831.

also be given to any liquidation of original capital at any time prior to or during the taxable year.[53] In the case of a reorganization, consolidation or change of ownership of a trade or business after January 1, 1911, the invested capital of the predecessor for the prewar period is deemed to be the invested capital for such period of the new organization now engaged in the business.[54] In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property after March 3, 1917 (if 50% or more of the interest or control remains in the same persons), the assets so transferred will not be allowed a higher valuation in determining invested capital than under the previous ownership. If the previous owner was not a corporation, the value of the assets in the hands of the present owner will be taken at the cost to the previous owner when acquired by him.[55] The law contemplates that the invested capital shall be the average amount employed for a full year and if a corporation makes a return for a period less than twelve months the invested capital must be prorated accordingly. Thus although a corporation actually had an invested capital of $100,000 and was in existence for six months of the year 1918, for the purpose of this tax its invested capital would be considered as being only $50,000.[56] With respect to the value to be placed upon the several classes of assets of a corporation, such assets are divided into three classes: (1) cash paid in; (2) tangible property paid in and (3) intangible property paid in. Regardless of the character of the asset when paid in a further distinction is made with respect to the character of the asset during the taxable year. For this purpose the assets are divided into two classes: (1) admissible assets; and (2) inadmissible assets. The several classes and the adjustments required to be

53 See Reg. 41, Art. 42.

54 See p. 693.

55 See p. 682 for more complete statement.

56 See letter from Treasury Department dated March 20, 1918; W. T. S. 1919, ¶ 764. This amounts to an assumption that if the corporation had been in business for the full year it would have earned twice the amount it did during the six months period. If it can be shown that by the very nature of its business no more income would have been earned had the corporation been in existence for the full year, it would seem that the case is one for remedial action under § 327. See p. 692.

made with respect to each and to all as a whole are discussed in the following paragraphs.

Cash Paid In. The amount of cash paid to a corporation in exchange for its stock is invested capital and remains such whether used for the purpose of acquiring tangible or intangible property.[57] Thus, if the stockholders of a corporation have actually and in good faith paid in cash for its stock, such cash may be used to purchase good will, patents, copyrights, trademarks or trade-brands, and the intangible assets so acquired may be included in invested capital to the extent of their cost. It is only when such intangible assets are acquired in exchange for stock that the restrictive provisions of the statute limiting the amount of intangible assets which may be included in invested capital apply. If, however, the cash is used to acquire inadmissible assets, the invested capital will be reduced accordingly, since inadmissible assets reduce invested capital. But if the vendors of the property retain an interest or control of 50% or more in the property and it was transferred after March 3, 1917, the value for invested capital is limited as indicated below, whether the property is tangible or intangible.[57a]

STOCK SOLD AT A DISCOUNT. Only the net proceeds of stock sold at a discount will be recognized as paid-in capital for purposes of invested capital. Stock sold at par for cash, when a commission is afterwards paid to a broker, is held to be stock sold at a discount.[58]

BONUS STOCK. Capital stock issued as a bonus in connection with the sale of a corporation's bonds may not be included in invested capital unless the corporation proves to the satisfaction of the Commissioner that such stock bonus enabled the corporation to secure a higher price for the bonds than it could otherwise have secured. Whenever this fact is established, bonus stock may be included in invested capital to the extent of the difference between the selling price of the bonds and the price at which they could have been sold if issued without such stock bonus. The excess of the face value of such bonds over the price at which they

[57] Revenue Act of 1918, § 326 (a).

[57a] See Revenue Act of 1918, § 331. See p. 682.

[58] Letter from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 1041.

could have been sold if issued without the stock bonus is deemed discount and is subject to amortization.[59]

Tangible Property Paid In. When stock or shares have been issued for tangible property the actual cash value of the tangible property at the time it is paid in becomes invested capital. If the actual cash value of such tangible property exceeds the par value of the stock issued therefor,[60] the excess over the par value may be treated as paid-in surplus, provided it is shown to the satisfaction of the Commissioner that the value of the property was clearly and substantially in excess of the par value of the stock. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (a) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (b) certification of the assessed value in the case of real estate; and (c) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. No claim will be allowed for a paid-in surplus in a case in which the additional value has been developed or ascertained subsequently to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims of this character will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be clear and explicit.[61] The

59 Reg. 45, Art. 832.

60 The par value of stock or shares, in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued (Revenue Act of 1918, § 325).

61 Reg. 45, Art. 836. In 1917 the rule was: Where it can be shown by evidence satisfactory to the Commissioner that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time. Evidence

Commissioner is required to keep a record of all cases in which tangible property is included in invested capital at a value in excess of the par value of the stock issued therefor, containing (a) the name and address of the taxpayer, (b) the business in which it is engaged, (c) the amount of invested capital and net income shown by the return, (d) the value of the tangible property at the time it was paid in, (e) the par value of the stock specifically issued therefor, and (f) the amount included as paid-in surplus. He is also required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions ordinarily imposed on him with respect to making public the contents of tax returns.[62]

Definition of Tangible Property. The term "tangible property" means stocks, bonds, notes and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property.[63] A contract may be treated as tangible property only after the submission of a full statement as to its exact nature showing to the satisfaction of the Commissioner that it relates to rights in tangible property to such an extent that its value arises chiefly therefrom.[64]

Evidences of Indebtedness. Enforceable notes or other evidences of indebtedness, either interest bearing or non-interest bearing, of the subscriber received by a corporation upon a subscription for stock may be considered as tangible property in computing its invested capital to the extent of the actual cash value of such notes or other evidences of indebtedness at the time when paid in, but

tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares. (Reg. 41, Art. 63.) This ruling was supported by the language of the 1917 Law (§ 207 (a)) which permitted the inclusion of "the actual cash value of tangible property paid in * * * at the time of such payment."

62 Revenue Act of 1918, § 326 (a).

63 Revenue Act of 1918, § 325 (a). The 1917 Law contained no definition of intangible property, but the Treasury Department held that the term included stocks, bonds, bills and accounts receivable, notes and other evidences of indebtedness and leaseholds. (Reg. 41, Art. 47.)

64 Reg 45, Art. 811.

only (a) if such notes or evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute, and not as conditional, payment in whole or in part of the stock subscription.[65]

VALUE OF PROPERTY AS OF JANUARY 1, 1914. Under the 1917 Law the value of tangible property as of January 1, 1914, could be taken in the case where such property had been paid in for stock or shares prior to that date, but not in excess of the par value of the stock or shares. No such provision appears in the 1918 Law and the value must in all cases be determined as of the time of acquisition.[66]

Intangible Property. The term "intangible property" means patents, copyrights, secret processes and formulæ, good will, trade-marks, trade-brands, franchises and other like property.[67] Most contracts are intangible property and in the absence of a specific ruling by the Commissioner to the contrary should be so regarded for the purpose of making returns. Associated Press, and similar franchises, and subscription lists and mailing lists are intangible property.[68] The actual cash value of intangible property paid in for stock or shares must be determined in the light of the facts in each case. Among the factors to be considered are (a) the earnings attributable to such intangible assets while in the hands of the predecessor owner; (b) the earnings of the corporation attributable to the intangible assets after the date of their acquisition; (c) representative sales of the stock of the corporation at or about the date of the acquisition of the intangible assets; and (d) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value

[65] Reg. 45, Art. 833.

[66] Cf. Revenue Act of 1917, § 207 and Revenue Act of 1918, § 326.

[67] Revenue Act of 1918, § 325 (a). In the 1917 Law patents were not defined as intangible property. (Revenue Act of 1917, § 207.) Under the 1917 Law the term "other intangible property" as used in § 207 was construed to mean property of a character similar to good will, trade marks and the other specific kinds of property enumerated in the same clause. Property not clearly of such character might be held to be tangible within the meaning of the law. (Reg. 41, Art. 47.) Patents had a status intermediate between tangible and intangible property.

[68] Reg. 45, Art. 811.

for intangible property paid in for stock or shares should file with its return a full statement of the facts relating to such valuation.[69] In cases where stock has been issued for intangible property the following rules apply:

INTANGIBLE PROPERTY PAID IN PRIOR TO MARCH 3, 1917. Where intangible property was paid in prior to March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor [70] or (c) in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917,[71] whichever is the lowest.[72] Illustration: assume the par value of the capital stock of a corporation issued and outstanding on February 1, 1917, was $100,000. On February 2, 1917, it issued an additional $100,000 par value of stock for intangible property having a cash value of $100,000. Applying the foregoing rule, (a) equals $100,000; (b) equals $100,000 and (c) equals 25% of $200,000 (the par value of the stock outstanding on March 3, 1917). Therefore (c), or $50,000, is all that may be considered as invested capital representing such intangible property. A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in a later paragraph.[73]

69 See Reg. 45, Art. 851.

70 The par value of stock or shares in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued. (Revenue Act of 1918, § 325.)

71 Under the 1917 Law it was held that intangible property bona fide purchased prior to March 3, 1917, with stock having no par value could be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase or in an amount not exceeding 20% of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue. (Reg. 41, Art. 58.)

72 Revenue Act of 1918, § 326 (a) 4, 5. In the case of a reorganization in which the capital stock is increased but the control of the business remains in the same hands the value of the stock issued for intangible property must be determined with reference to the capitalization of the old company and not the capitalization of the new company. (Letter from Treasury Department dated March 14, 1918.)

73 See p. 663.

INTANGIBLE PROPERTY PAID IN ON OR AFTER MARCH 3, 1917. Where the intangible property was paid in after March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest. Illustration: assume a corporation has $200,000 par value of capital stock outstanding on December 30, 1917. On December 31, 1917, it issues an additional $100,000 of capital stock for intangible property having a cash value of $100,000. Applying the foregoing rule: (a) equals $100,000; (b) equals $100,000; and for the taxable year 1918 (c) equals 25% of $300,000. Therefore the invested capital representing such intangible property is $75,000. But if the same intangible property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital for 1918 representing the same value of intangible property would be only $50,000 instead of $75,000, since in that case the par value of the capital stock outstanding at the beginning of the taxable year would have been only $200,000.[74] A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in the following paragraph.

WHERE INTANGIBLE PROPERTY HAS BEEN PAID IN BOTH BEFORE AND AFTER MARCH 3, 1917. Where intangible property has been paid into a corporation before and also after March 3, 1917, a further limitation is imposed upon the value of the invested capital to represent in the aggregate all such intangible property. The law provides that in no case shall the total amount of invested capital representing intangible property paid in both before and after that date exceed in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.[75] Illustration: assume the par value of the capital stock outstanding February 1, 1917, was $100,000 and that $100,000 additional was issued for intangible property of the same cash value on February 2, 1917, and a

[74] Revenue Act of 1918, § 326 (a) 4, 5.
[75] Revenue Act of 1918, § 326 (a) 5.

further issue of $100,000 par value on December 31, 1917, for intangible property also having an equal cash value. Applying the first and second rules stated in the preceding paragraphs it is found that the invested capital with respect to the first intangible property is $50,000 and with respect to the second intangible property is $75,000, making the total for both $125,000. But applying the third rule the total invested capital representing both the property acquired on February 2, 1917, and that acquired on December 31, 1917, is reduced in the aggregate to $75,000. If the second property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital representing both properties would be reduced even lower, namely to $50,000, which amount would then represent 25% of the par value of the capital stock of the corporation outstanding January 1, 1918.[76]

Mixed Aggregates of Tangible and Intangible Property. The Revenue Act of 1918 [77] provides that where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively, the corporation shall be assessed by reference to representative corporations engaged in a like or similar trade or business.[78] Where stock or shares and bonds or other obligations have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. Where stock or shares have been issued for a mixed aggregate of tangible and intangible property and certain liabilities have been assumed in connection with the transaction, it will be presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named, unless it is shown by evidence satisfactory to the Commissioner that this presumption is not in accordance with the facts.[79]

[76] As to affiliated corporations see p. 708.

[77] Revenue Act of 1918, § 327 (c).

[78] See Revenue Act of 1918, § 328.

[79] Reg. 45, Art. 835. Under the 1917 Law it was held that where stock or

Surplus and Undivided Profits. Paid-in or earned surplus and undivided profits at the beginning of the taxable year may be included as invested capital. Surplus and undivided profits earned during the year may not be included.[80] Appreciation in values due to reappraisement cannot be regarded as paid-in or earned surplus.[81]

PAID-IN SURPLUS. Where it is shown by evidence satisfactory to the Commissioner that tangible property has been paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such payment clearly

shares (or stock or shares and bonds or other obligations) have been issued for a mixed aggregate of: (a) Tangible property, (b) Patents and copyrights, and (c) Good will or other intangible property, the following rules would govern: (1) In the absence of satisfactory evidence to the contrary, it was presumed in the case of a corporation, that its stock was issued for the following purposes in the order named: (a) Good will or other intangible property, (b) Patents and copyrights, and (c) Tangible property. (2) Upon the production by the taxpayer of evidence satisfactory to the Commissioner as to the actual values at the date of acquisition of (a) the tangible property and (b) the patents and copyrights, the sum of these two items could be applied against the total par value of the securities issued and the remainder was then deemed to represent the par value of the securities issued for the good will or other intangible property. (3) Cases where mixed aggregates of tangible and intangible property have been paid in for stock and bonds were, if the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment, treated as coming under the head of cases where the invested capital could not be satisfactorily ascertained and the tax was assessed accordingly. (Reg. 41, Art. 59.)

80 Revenue Act of 1918, § 326 (a). Under the 1917 Law some doubt existed as to whether or not surplus earned during the taxable year and actually employed in the business during a part of that year could not be included in invested capital. The Treasury Department ruled that it could not in the case of corporations and partnerships (Reg. 41, Art. 61) even though invested in bonds of the United States (T. D. 2541) or set up as "surplus" on the books or distributed in the form of stock dividends (Reg. 41, Art. 61) but that profits earned during the year could be included as invested capital of individuals (Id. Art. 69). The 1917 Law also provided that surplus or undivided profits in order to be included in invested capital should be "used or employed in the business," but the distinction, if any exists, between assets used and assets not used in the business of a corporation was too fine for practical purposes, and since the law elsewhere provided that all the income of a corporation should be deemed to be received from its trade or business, the Treasury Department ruled that all surplus or undivided profits would be deemed to be employed in the business, unless invested in inadmissible assets (Id. Art. 62).

81 Letter from Treasury Department dated March 5, 1918.

and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess will be deemed to be paid-in surplus. Substantially the same kind of evidence will be required to show the value in this case as is required in the case of tangible property paid in at a value greater than the par value of the shares issued therefor.[82]

Earned Surplus. Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence, or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.[83] Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the Act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the Act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its property in computing its surplus and undivided profits. Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in

[82] Reg. 45, Art. 837.
[83] Reg. 45, Art. 838.

prior years was insufficient or excessive, as the case may be. Where deductions for depreciation or depletion have either on the books of the corporation or in its returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[84]

Reserves. The amounts shown on the balance sheet as reserves may or may not be included as invested capital depending upon the character of the reserve.[85] Some reserves are merely subdivisions of the surplus account and are true surplus or undivided profits. Such reserves are, for instance, reserves for bad debts, reserves for contingencies, reserves for self-insurance, and reserves for Federal income and excess-profits tax. Any reserve the additions to which cannot be deducted as an expense in the return of income, may be considered as a part of the surplus and undivided profits for the purpose of invested capital. On the other hand, with perhaps only two exceptions, reserves, the additions to which may be deducted in ascertaining net income, cannot be included as invested capital. Among such reserves are reserves for depreciation (which are presumed to offset the loss in the assets) and reserves for state or local taxes in cases where the corporation reports on an accrual basis and the amounts carried to such reserves have been deducted. An exception to this general rule would appear to exist in the case of reserves for depreciation or depletion based upon the value of the property as of March 1, 1913, or in the case of depletion based on the value of a mine or oil or gas property thirty days after

[84] Reg. 45, Art. 839.

[85] "Reserves" have been variously classified by accountants. They are classified by Mr. Esquerré in "Applied Theory of Accounts" as follows: "1. Reserves for Depreciation; 2. Operating Reserves; 3. Reserves for Surplus Contingencies; 4. Reserves for Redemption of Debt; 5. Secret Reserves; and 6. Reserves for Exhaustion of Physical Assets." Reserves are classified by Mr. Hatfield in "Modern Accounting" as follows: "1. Reserves created to provide a permanent increase of capital. (a) As an additional guaranty to creditors. (b) To provide for extension of its fixed or other capital assets. 2. Reserves created to provide an additional capital which can be used to cover unusual losses or to provide for other emergencies without encroaching on the nominal capital. 3. Reserves created to provide for equalizing dividends by retaining part of one year's profit to be used to make up scanty profits for other years."

discovery. These exceptional cases are referred to in the following paragraphs.

RESERVES FOR TAXES. Reserves set aside out of surplus or undivided profits of preceding years for payment of Federal taxes or state taxes not yet due can be included in invested capital for the taxable year if, and to the extent that, such taxes were not allowable deductions in computing net income for the preceding taxable years. Inasmuch as Federal income and excess-profits taxes are not deductible in computing net income subject to such taxes, reserves set aside for the payment of such taxes may be included in invested capital.[86] But amounts payable on account of income and excess-profits taxes for any year may be included in computing the surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates on which such taxes become due and payable.[87] A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. Where as a result of an audit by the Commissioner, or the acceptance of an amended return, or for any other reason, the amount of any such tax for the preceding year is subsequently changed, a corresponding adjustment will be made in the invested capital for the taxable year upon the same basis as if the corrected amount of the tax for the preceding year had been used in the original computation of the invested capital for the taxable year.[88]

RESERVE FOR DEPRECIATION OR DEPLETION. If any reserves for depreciation or for depletion are included in the surplus account it should be analyzed so as to separate such reserves and leave

86 Letter from Treasury Department dated March 20, 1918; W. T. S. 1918, ¶ 911.

87 Reg. 45, Art. 845; T. D. 2791. Prior to this Treasury Decision it was uncertain whether or not a corporation which indicated on its books of account that the excess-profits tax imposed on the income for 1917 was paid out of the earnings of 1918 need reduce its invested capital by reason of such payments. It was argued that the corporation had the option of paying the tax from either the income of 1917 or the income of 1918. This ruling is intended to apply a uniform rule in all cases regardless of whether or not the corporation set up a part of its surplus as reserves for Federal taxes.

88 Reg. 45, Art. 845.

only *real surplus.* Reserves for depreciation or depletion can not be included in the computation of invested capital, except to the following extent: (1) Excessive depletion or depreciation included therein and which if charged off could be restored may be included in the computation of invested capital,[89] and (2) where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital. For the purpose of computing invested capital depreciation or depletion computed on the value as of March 1, 1913, or as of any subsequent date must, if such value exceeded cost, be deemed a pro rata realization of cost and appreciation and be apportioned accordingly. Except as above provided value appreciation (even though evidenced by an appraisal) which has not been actually realized and, in respect of amounts accrued since March 1, 1913, reported as income for the purpose of the income tax can not be included in the computation of invested capital, and if already reflected in the surplus account it must be deducted therefrom.[90]

Patents. From the standpoint of assets a patent, or more particularly a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of seventeen years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income the amount so deducted can not now be restored in computing invested capital. Where, however, the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not

89 See Reg. 45, Art. 840.
90 Reg. 45, Art. 844.

to benefit the corporation in computing its taxable net income since January 1, 1909, any amount so written off may be restored in computing invested capital, if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. Any amount so restored may not be written off by way of deductions from taxable net income in any subsequent year or years. Where a corporation has charged to current expenses the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, can be restored in computing invested capital. In respect of expenditures made before January 1, 1909, a corporation now seeking to restore them must be prepared to show to the satisfaction of the Commissioner that all such items are proper capital expenditures. It can not be said that the correct computation of surplus and undivided profits necessarily requires a deduction in respect of the expiration of patents. It follows, therefore, that where a corporation in the exercise of its option has not written down the cost of patents, it is not ordinarily necessary to reduce the surplus and undivided profits in computing invested capital, whether the patents have been acquired for stock or shares or for cash or other tangible property. Due consideration will be given to the facts in any case in which this rule seems obviously unreasonable.[91]

Property Taken for Debt. Real or personal property taken by a corporation in payment or satisfaction of a debt, or property received in exchange for other property, will be an admissible asset at its fair market value upon receipt. The profit or loss, if any, resulting from the transaction will not be reflected in invested capital until the succeeding taxable year.[92]

Discount on Sale of Bonds. Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise carried as an asset, and is so reflected in the

[91] Reg. 45, Art. 843.
[92] Reg. 45, Art. 847.

surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.[93]

Bank Discount. Only the amount of discount which has actually been reported by a bank in a prior year as taxable income and credited to surplus account may be included in surplus as of the beginning of the taxable year.[94]

Current Profits. Profits earned during any year can not be included in the computation of invested capital for that year, even though during the year such profits are set up as surplus on the books or assumed to be distributed in the form of stock dividends. If a dividend is declared and paid during any year out of the profits of that year and the stockholders pay back into the corporation all or a substantial part of the amount of such dividends, the amount so paid back can not be included in the computation of invested capital unless the corporation shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.[95]

Surrender Value of Insurance Policies. Premiums paid by a corporation for insurance on the lives of its officers and employees payable to it cannot be deducted as expenses in computing taxable income. Such insurance policies are considered tangible property and may be included as invested capital of the corporation at their cash surrender value at the beginning of the taxable year. The whole amount of premiums paid on such insurance can not be included in surplus, but the surplus will be considered as increased as of the beginning of each taxable year by the amount added to the cash surrender value of the policy.[96]

Additions to Surplus Account. A corporation's books of accounts will be presumed to show the facts. If it claims that its capital or surplus account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent: (1) Excessive depreciation heretofore charged off on property still owned and in use, if it is now shown by satisfactory proof to have been excessive and such excess is substantial in amount, whether or not disallowed by the Commissioner

[93] Reg. 45, Art. 848.
[94] Reg. 45, Art. 849.
[95] Reg. 45, Art. 850.
[96] Reg. 45, Art. 846.

as a deduction from net income, may be restored to the surplus account. No such amount may be restored, however, unless it is shown that adequate depreciation has been deducted upon all other property of the corporation still in use, nor in any case in which such amount has been allowed as a deduction for amortization[97] or in which the cost of the property has been recovered through being included in the price of goods or services, as for example, in the case of patterns, dies, plates, special tools, etc., or under a munition contract with a foreign government. (2) Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures, or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the surplus account when such assets are still owned and in active use by the corporation during the taxable year. Special tools, patterns, and similar assets will not be assigned any value if their cost has been recovered through having been included in the price of goods. If their cost has not been so recovered and they are held for only occasional use, they will not be assigned a value in excess of the fair value based upon the earnings actually arising from their current use, and in no case will such value be more than the cost less depreciation. Assets of this kind not in current use will not be valued at more than their nominal or scrap value. (3) Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus account only to the extent that the corporation specifically paid such amounts for the intangible property as such.[98] (4) Adjustments necessary to correct other errors found in the books of account may be made.[99]

Limitation of Additions to Surplus. Additions to surplus which a corporation may desire to make under the preceding par-

[97] See Revenue Act of 1918, § 234 (a) 8.

[98] It was also held under the 1917 Law that although large sums may have been spent in advertising and thereby an extensive good will may have been created, the sums so spent could not be considered as amounts paid for good will if the amounts were charged to general expense from time to time. Good will could be included only when bought and paid for specifically as such. (Letter from Treasury Department dated March 5, 1918.)

[99] Reg. 45, Art. 840.

agraph fall broadly into 2 classes: (1) To correct returns of income for prior years in which actual errors have been made, as for example where excessive depreciation has been deducted, additions to plant and equipment or other capital charges have been charged off as an expense, inventories have been taken upon a wrong basis of valuation, etc. (2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc. Adjustments falling in class (1) will be permitted for all years, whether before or after March 1, 1913, provided amended returns of income are filed for each year in which an erroneous return has been made. Due consideration will be given to the assessment of penalties in any case in which a fraudulent return has been made. Adjustments falling in class (2) cannot be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction cannot now be revised, and amended returns in respect thereof cannot be accepted. The corporation is required to submit with its return a statement of the additions proposed, specifying the kinds and amounts of property involved, the years in which the expenditures were made, and the method followed in distinguishing between capital outlays and current expenses, and showing that adequate provision has been made for depreciation, obsolescence and depletion of such of the assets affected by the additions as are subject to recognized depreciation, obsolescence or depletion. In any case in which there is an operating deficit amounts restored must first be set off against the deficit and only the excess can be actually included in the computation of invested capital.[100]

Property Paid in and Subsequently Written Off. Where tangible or intangible property has been paid in to a corporation for stock or shares or as paid-in surplus, and has subsequently been in whole or in part written off the books, the amount so written off may upon evidence satisfactory to the Commissioner be restored to the capital or surplus account subject to the following limitations: (1) The amount restored must be reduced by a proper

[100] Reg. 45, Art. 841.

deduction for any depreciation, obsolescence or depletion; and (2) the aggregate amount included in computing invested capital on account of such property must not exceed the amount which might have been included if such property had not been written off.[101]

Admissible Assets. The term "admissible assets" means all assets other than inadmissible assets. Organization expenses and deferred charges against future income are admissible assets. Admissible assets must be valued in accordance with the provisions of the law regarding invested capital.[102] Thus, for example, intangible property paid in for stock or shares is an admissible asset, but it cannot be valued at an amount in excess of that at which it may be included in computing invested capital under the provision of law limiting such amount to 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, or at the beginning of the taxable year accordingly as such property was paid in prior to or on or after March 3, 1917.[103]

Inadmissible Assets. The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States) the dividends or interest from which are not required to be included in computing net income. Where, however, the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation upon the deduction of interest,[104] the corresponding part of such assets is not deemed to be inadmissible.[105] A corporation cannot by including the income from inadmissible assets as taxable income create the right to have such assets considered admissible assets.[106] Inadmissible assets will for the purpose of discussion in the following para-

101 Reg. 45, Art. 842.

102 Revenue Act of 1918, § 325.

103 Reg. 45, Art. 818. Revenue Act of 1918, § 326 (a) 4, 5. Good will so far as it is built up and developed by advertising not charged to expense may be included in invested capital. A corporation may in the future exercise an option and, if it so desires, treat advertising as a capital item, not deducting it as an expense, in which case it may become entitled to include a pro tanto amount of good will in its invested capital and make an addition to surplus accordingly.

104 See Revenue Act of 1918, § 234 (a) 2.

105 Revenue Act of 1918, § 325.

106 Reg. 45, Art. 815.

graphs be divided into three classes, (1) stocks of domestic corporations (2) stocks of foreign corporations and (3) bonds and other obligations.

STOCK IN FEDERAL RESERVE BANK. Federal Reserve Bank stock, held by a member bank, is an inadmissible asset in determining invested capital.[107]

STOCK OF DOMESTIC CORPORATIONS. The statute apparently intends that stocks of domestic corporations are *ipso facto* inadmissible assets in computing the invested capital of the stockholder. The law provides that the term "inadmissible assets" means "stocks * * * the dividends * * * from which is [are] not included in computing net income."[108] Hence it follows that it is immaterial whether the corporation whose stock is held actually pays dividends thereon or not, or whether its operations are carried on within or without the jurisdiction of the United States. Although many corporations find it necessary for business reasons to hold stock in other corporations which do not pay dividends and such investment is in fact a necessary and proper investment, as for instance where several corporations may own the stock of storage, warehouse or terminal companies for their joint benefit (such jointly held corporation not being intended to pay dividends) the stock is nevertheless inadmissible under a literal interpretation of the law. To hold that stock of a domestic corporation is admissible if the corporation paid no dividends during the taxable year, but inadmissible if the corporation paid dividends and the same were not included in the net income of the stockholder, would be to establish an impracticable rule, and one plainly not intended by the language of the law. Hence, it has been ruled that the failure to pay or to receive dividends does not change the status of stock as an inadmissible asset.[109] Apparently the only way that stock of a domestic corporation can become an admissible asset is by selling the stock, in which case the profit is included in net income and all or a portion of the value of the stock becomes an admissible asset, as is more fully stated in a subsequent paragraph.

107 Letter from Treasury Department dated March 13, 1919; W. T. S. 1919, ¶ 1014.

108 Revenue Act of 1918, § 325 (a).

109 Reg. 45, Art. 815.

STOCK OF FOREIGN CORPORATIONS. If a foreign corporation pays an income tax to the United States on any part of its income, its dividends are not taxed as income when received by a domestic corporation [110] and it follows that the stock of such foreign corporation is an inadmissible asset. On the other hand, if such foreign corporation pays no income tax to the United States its stock is an admissible asset.[111]

BONDS OR OTHER OBLIGATIONS. The bonds or other obligations which are inadmissible assets are only those "the interest from which is not included in computing net income."[112] Bonds and securities of industrial or railroad corporations—domestic or foreign—are admissible, even though the bond may have a so-called "tax-free covenant." Bonds issued by exempt corporations are admissible assets. Bonds and obligations of the United States are admissible although the interest may be exempt. Such bonds, however, are only bonds of the Federal Government and not of its possessions. Bonds and obligations which are inadmissible assets are those issued by a state or territory (or a political subdivision of either, i. e., county, city, township, etc.), the District of Columbia and the possessions of the United States, and also securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916.[113] Bonds of the War Finance Corporation are admissible if the income therefrom is subject to the tax, but that part of the principal amount of such bonds with respect to which interest may be exempt from excess-profits tax is inadmissible. Thus, bonds of the War Finance Corporation the principal of which does not exceed $5,000 are inadmissible assets, and bonds of the War Finance Corporation the principal of which exceeds $5,000 are admissible assets.[114]

Inadmissible Assets May Become Admissible. Under two conditions assets which are otherwise inadmissible become in whole

110 Letter from Treasury Department, dated June 9, 1919; I. T. S. 1919, § 3427. See p. 297.

111 The rule was different under the 1917 law. See Reg. 41, Art. 27. But it seems that the rule stated in the text is applicable to assessments under that law as well as the present law.

112 Revenue Act of 1918, § 325 (a).

113 Reg. 45, Arts. 815-816.

114 Official Announcement by the Bureau of Internal Revenue, dated April 5, 1919. See Chapter 18.

or in part admissible: (1) Where the inadmissible asset has been sold during the year and the profit thereon is included in net income, and (2) where inadmissible assets have been purchased or carried during the year with borrowed money and the interest paid on such borrowed money is not allowed to be deducted in ascertaining the net income.[115] Where inadmissible assets have been sold or otherwise disposed of, the total income from such assets including the profit on the sale and the interest or dividends received during the year is first ascertained. Secondly, the percentage of the entire net income attributable to the profit on the sale of the asset is ascertained and the same percentage of the intangible asset becomes invested capital for the length of time such asset was owned by the corporation.[116] In the second class of cases it seems that the interest received from the inadmissible asset should be compared with the interest paid upon the money borrowed to purchase or carry such asset. Thus, if the interest received is $100 and the interest paid on the borrowed money is $75, three-fourths of the inadmissible asset becomes admissible (since three-fourths of the interest is in effect included in taxable income). This applies separately to each issue or class of inadmissible securities held by a corporation. For example, it may hold A company stock costing $100,000 and B company stock costing $200,000. During the year it receives $8,000 in dividends from A company and $5,000 from B company, and on September 30 sells part of its B company stock at a profit of $3,000. For the period from January 1 to September 30 $75,000 of its holdings of B company stock become admissible. After September 30 its remaining holdings of B company stock are inadmissible, but the proceeds of the sale are admissible unless invested in admissibles.[117]

Reduction of Invested Capital by Inadmissible Assets. From invested capital must be deducted a percentage thereof equal

115 See Revenue Act of 1918, § 234 (a) 2, also p. 358.

116 Under the 1917 Law it was held that wherever income consisted partly of gains or profits subject to the excess-profits tax arising from trading in stocks, bonds, etc., the dividends or interest on which were not subject to such tax, and partly from such dividends or interest, there could be included in the invested capital an amount which bore the same ratio to the total amount invested in such stock or bonds as the amount of such trading profits bore to the total amount of trading profits and dividends or interest. (Reg. 41, Art. 45.)

117 Reg. 45, Art. 817.

to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the year.[118] In other words, after the invested capital has been determined without reference to inadmissible assets but eliminating borrowed capital, the invested capital so determined is reduced by taking a percentage equal to the percentage of inadmissible assets to all the assets held during the taxable year.[119] For the purpose of ascertaining the deductible percentage the amount of inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount held at the end of the year. The total amount of admissible and inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount at the end of the year. If at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change should be averaged exactly from the date on which it occurred. In any case where the Commissioner finds that either amount determined as above provided does not substantially reflect the average situation throughout the year, and that the amount of each kind of assets held on a given day of each month throughout the year or at more frequent regular intervals can be determined, the amount of inadmissible assets and the amount of both kinds of assets held during the year will be determined by averaging the amounts held at such several times. In making these computations the valuation at which each asset is carried must be adjusted in accordance with the provisions of the statute and of the regulations relating to the valuation of assets for the purpose of computing invested capital including in such adjustment the amount of reserves for depreciation, depletion, amortization and other reserves which represent the valuation of assets. It is immaterial whether any asset was acquired out of invested

118 Revenue Act of 1918, § 326 (b).

119 Under the 1917 Law it was ruled that only so much of the admissible assets as exceeded the borrowed money need be deducted from invested capital. See letter from Treasury Department dated April 2, 1918; W. T. S. 1918, ¶ 923 and letter dated May 17, 1918, Id. ¶ 955.

capital, or out of profits earned during the year, or borrowed capital.[120]

Borrowed Capital. The term "borrowed capital" means money and other property borrowed whether represented by bonds, notes, open accounts, or otherwise.[121] Invested capital does not include borrowed capital.[122] Where the amount of borrowed capital is abnormal, however, the taxpayer may apply for assessment by reference to representative corporations.[123] Any interest in a corporation represented by bonds, debentures or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and cannot be included in computing invested capital. Any such preferred stock may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors.[124] Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is largely a question of fact. Thus, indebtedness to stockholders actually cancelled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the business representing salaries of officers in excess of their actual withdrawals, or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the par-

120 Reg. 45, Art. 852. As to affiliated corporations see p. 708.

121 Revenue Act of 1918, § 325 (a). Under the 1917 Law it was held that the term "money or other property borrowed" included not only cash or other borrowed property which could be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer was entitled to an interest deduction in computing net income. (Reg. 41, Art. 44.)

122 Revenue Act of 1918, § 326 (b).

123 See p. 699.

124 Reg. 45, Art. 812. Where the principal stockholder of a corporation loans money to the corporation and, in order to protect the credit of the corporation an agreement is signed to the effect that the lender shall be deferred to all other creditors and shall receive one per cent additional interest in consideration thereof, which interest is not deducted by the corporation as expense, the amount of the loan cannot be included in invested capital as preferred stock. (Telegram from Treasury Department dated April 4, 1919; W. T. S. 1919, ¶ 1021.)

ticular case. The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholder's or officer's right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital.[125] Items such as deposits or amounts due to other banks shown in the balance sheet of a bank, unexpired subscriptions shown in the balance sheet of a publishing concern, etc., are deemed liabilities and can not be included in computing invested capital.[126]

Computing Invested Capital. In computing invested capital the first step is to add together the paid-in capital and paid-in or earned surplus and undivided profits (under whatever name the same may be called) as shown by the books at the beginning of the taxable year. The total thus obtained is to be adjusted for any asset or item which it covers that is not carried on the books at the valuation prescribed by law.[127] After the various adjustments are made the adjusted total of the capital and surplus account will represent the invested capital at the beginning of the taxable year. If there has been any change made during the taxable year in the amount of invested capital, the reduction or increase must be noted in order to average the invested capital for the year. Whenever any corrections are made in respect of the capital stock or surplus, corresponding corrections must be made in the respective asset items in the balance sheet of the taxpayer accompanying the return.[128] But it is not necessary that the books also be changed provided some permanent record of the adjustments is kept.[129]

Adjustments Which Increase Book Values of Assets. The adjustments which may increase the book value of the assets representing capital and surplus at the beginning of the year (and thus increase the surplus for purposes of invested capital) are stated in the preceding paragraphs.[130] Briefly summarized they are (a) the value of tangible property paid in in excess of the par value of the stock issued therefor; (b) additions to the cap-

125 Reg. 45, Art. 813.
126 Reg. 45, Art. 814.
127 This was the rule under the 1917 Law. See Reg. 41, Art. 53.
128 Reg. 41, Art. 53.
129 Letter from Treasury Department dated March 19, 1918.
130 See p. 671.

ital account due to restoring to the capital account the value of assets the cost of which has been charged to expense; (c) reinstating the value of assets which has been unduly reduced on the books of the company, and (d) the inclusion of reserves or such parts of reserves as are in fact surplus or undivided profits. In support of the claim for additional invested capital with respect to any of these items it is necessary to file statements showing the information indicated in the respective paragraphs above.

Adjustments Which Reduce the Book Value of Assets. Assets may be carried on the books at a valuation greater than that which the law expressly allows or contemplates. In such cases the value of such assets must be reduced to within the limit allowed by law and the capital, surplus or undivided profits of a company reduced accordingly. Cases in which adjustment must be made to reduce the book value are stated in the following paragraphs.

As to Value of Intangible Assets. As stated above in the paragraphs relating to intangible property paid in[131] the value thereof must be reduced to the lowest of three values: (a) the actual cash value at the time of acquisition; (b) the par value of the stock issued therefor, or (c) 25% of the par value of the stock outstanding on March 3, 1917, or at the beginning of the taxable year as the case may be. The difference between such minimum value and the value at which the assets are carried on the books of the company is the amount to be deducted in this adjustment.

As to Treasury Stock. When any treasury stock is returned to the corporation as a gift or for a consideration substantially less than its par value, the stock so returned may not be treated as a part of the stock issued or exchanged for property. The proceeds derived in cash or its equivalent from the resale of such treasury stock should however be included in the invested capital, if retained and employed in the business.[132] The difference between the par value of the treasury stock so returned as a gift and the amount of cash or its equivalent which was derived from the resale of such stock is required to be deducted from invested capital.[133] Where a corporation either directly or indirectly, as

131 See p. 661.

132 Reg. 41, Art. 54; Reg. 45, Art. 861.

133 See Form 1120 for 1918, Schedule G3. There may be cases, however,

for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. The full amount derived in cash or its equivalent from the resale of such stock may be included in invested capital from the date of such resale, unless such stock had been purchased out of earnings of the taxable year.[134]

As to Value of Assets Acquired in Reorganization. In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, certain reductions may be necessary in the book values of the new owner, if such book values reflect the value of the property at the time it was acquired by such new owner. Such reduction is necessary only in cases where 50% or more of the interest or control in such trade or business or property remains [134a] in the same persons, or any of them. In such cases no asset so acquired will, for the purpose of determining invested capital, be allowed a greater value than would have been allowed in computing the invested capital of the previous owner if such asset had not been so transferred to the new owner. In other words, if the previous owner was a corporation and 50% or more of the interest or control of the new corporation remains in the hands of any of those who controlled the old corporation, the intent of the statute

where the subsequent return of stock to the corporation is in fact equivalent to an additional contribution of capital equal to the amount received by the corporation on the resale of such stock. Where stock has been issued for property and a part of the stock is returned to the treasury of the corporation, the presumption is that the property was consciously overvalued, but this presumption cannot stand if contrary to fact.

134 Reg. 45, Art. 862.

134a It seems that under the provision in its present form (Revenue Act of 1918, § 331) when the ownership of the trade or business or property ceases to "remain" to the extent of 50% in the same persons, the restriction no longer applies.

seems to be that the invested capital of the new corporation cannot be increased as to such property beyond the amount which would have been allowed to the old corporation had it retained the assets. This is true whether or not the assets were paid for by the new corporation in stock or in cash.[135] If the previous owner was not a corporation, then the value of any asset so transferred must be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost may be made for any charge or expenditure deducted as expense, or otherwise, on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.[136] In all such cases the reduction to be made is the difference between (a) the book value of such assets, and (b) in case the previous owner was a corporation, the value at which the asset would have been considered invested capital to it, or (c) in case the previous owner was an individual the cost of such asset to such owner, as indicated above.

As to Values Marked up on the Books of Account. Invested capital cannot be based upon an appraisement showing the value as of any date subsequent to the date of acquisition.[137] Therefore, if a corporation has marked up the value of any of its assets the amount by which the original book values have been so increased must be deducted.

As to Inadequate Allowance for Depreciation or Depletion. Where the corporation has not duly marked down the value of its property subject to depreciation, or set up a depreciation reserve to provide for replacement of values lost by depreciation, from the time the property was acquired down to the beginning of the taxable year, the proper amount of depreciation suffered during that period must be computed and deducted from the value

135 Under the 1917 Law this restriction on the value of assets acquired on a reorganization after March 3, 1917, applied only to cases where the asset was not paid for specifically as such in cash or tangible property, (Revenue Act of 1917, § 208; Reg. 41, Art. 501) but under the present law it applies also to cases where payment may have been made in cash or by tangible property. (Revenue Act of 1918, § 331.)

136 Revenue Act of 1918, § 331.

137 Reg. 45, Art. 831; Letter from Treasury Department dated March 5, 1918.

of the assets in order to reach their present value at the beginning of the taxable year.[138] Since the law contemplates that the invested capital shall be measured by the value of the original contribution of the stockholder to the corporation, paid-in surplus representing tangible property need not be reduced by reason of depreciation. All adjustments necessary on account of inadequate or excessive depreciation should be made in connection with *earned* surplus or undivided profits. Therefore, if a corporation is properly entitled to add to its invested capital in the form of paid-in surplus an amount representing excess in value of property, over the consideration paid therefor, such paid-in surplus need not be reduced on account of depreciation of the property on which the excess value is claimed. It should be borne in mind, however, that while paid-in surplus as indicated above, need not be reduced on account of depreciation, such adjustment must be made in *earned* surplus or undivided profits, and the computation must be based not on the cash paid or stock issued for the property but on its actual value at the time acquired for the purpose of computing the allowable addition to paid-in surplus.[139] Similar reduction must also be made in case of inadequate allowance for depletion.[140]

As to Losses. Where a loss has taken place, and the value of the asset has not been marked down accordingly, the amount of such loss must be deducted in this adjustment. But where a loss has taken place it will be taken into account only to the extent that it has wiped out earned surplus. The amount of the original capital contributed by the stockholders is not reduced by reason of the loss, but no new surplus can be included as invested capital until the full loss chargeable against the capital account has been made good.[141] It seems that a corporation to which a certain amount of capital was once contributed, and which has not paid back any part thereof to its stockholders, either directly or indirectly, is allowed to claim the entire amount originally contributed as invested capital, regardless of losses which may have impaired such capital, provided the corporation has no surplus

138 See Reg. 41, Art. 42.

139 Letter from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 1042.

140 See p. 663.

141 Letter from Treasury Department dated March 19, 1918; Reg. 45, Art. 860.

against which the loss can be charged. In other words, a corporation which has a deficit instead of a surplus may disregard the deficit in the computation of its invested capital. Losses which must be taken into consideration under this adjustment are those which have been actually sustained. The mere depreciation in market value of assets is not considered to be a loss impairing invested capital. Thus, stock of other corporations may have been purchased at par and at the beginning of the taxable year may have a market value of only 75. Nevertheless, until the stock is sold, it may for purposes of invested capital be carried at its original cost, and if the corporation has marked the value down to market, it may restore the value to original cost. On the other hand, such marking down of assets to market (except in the case of dealers who inventory their stock) does not create a loss which may be deducted in computing the net income. In the case of dealers who inventory their stock, the inventory value would govern and the cost value cannot be restored.

Allowance for Amortization under Munition Manufacturer's Tax. The Munition Manufacturer's tax was laid "upon the entire *net profits* actually received or accrued," from the sale or disposition of specific munitions, and it was provided in Section 302 "That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States, the following items: * * * (f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants." It is apparent from this language that the amortization allowance in question was authorized for the purpose of computing "net profits," not "net income." The right to make a deduction for amortization in computing net income for the income tax did not exist and was repeatedly denied by the Treasury Department prior to the passage of the Revenue Act of 1918. It is to be noted further that the taxes imposed by Title II of the Revenue Act of 1917 and Title III of the Revenue Act of 1918 were explicitly laid upon "net income," and were in a variety of ways impressed with the stamp and character of an income rather than

a munition manufacturer's tax. They are in no sense mere continuations or expansions of the tax imposed by Title III of the Revenue Act of 1916. It follows, therefore, that the deduction for amortization under the Munition Manufacturer's Tax law was not allowed for income tax purposes and should not now be permitted to affect the surplus or any other element entering into the "invested capital" employed for purposes of the war-profits and excess-profits taxes. In ruling upon a particular case the Treasury Department stated: "This conclusion is supported by the character of the amortization allowance in question. It was in many respects quite dissimilar from the depreciation and depletion allowances. It was not based upon the fact that plant and equipment acquired in the year 1916 or earlier for the manufacture of munitions, actually depreciated in use or market value during the taxable year 1916. There was in general no such depreciation in value or impairment of useful life. Account was taken 'of the exceptional depreciation of special plants' but the principal allowance was 'for the amortization *of the values* of buildings and machinery,' whether those values increased or decreased in the immediate future. The principal amortization allowance looked to the establishment of a special fund to recoup exceptional war costs when war uses had ceased; it did not imply that there had been or would be any immediate impairment of physical assets, such as is covered by the depletion allowance, or any immediate exhaustion, wear, tear or obsolescence in excess of the amount covered by the depreciation allowance. It was, as stated, a special allowance peculiar to this tax, designed possibly to moderate the (then) exceptionally high rates of the Munition Manufacturer's Tax." [142]

As to Inadmissible Assets. The adjustment by way of reduction of invested capital which must be made with respect to inadmissible assets is indicated in an earlier paragraph on that subject.[143] In the case of a corporation which has no borrowed money the reduction will equal the value of the inadmissible assets. In case the corporation has borrowed money the amount to be deducted is arrived at by deducting such proportion of the invested

142 Letter from Treasury Department dated August 13, 1919; W. T. S. 1919, ¶ 1051.

143 See p. 677.

capital (excluding borrowed capital) as the proportion of inadmissible assets is to the total of inadmissible and admissible assets.[144] Under the 1917 Law adjustments for inadmissible assets were made on the theory that the borrowed money was used to purchase or carry the inadmissible assets and only the excess of such assets over the borrowed money was deducted from invested capital. Under the present law, the adjustment seems to be on the theory that capital, surplus and borrowed money are represented by the inadmissible assets in proportion to the amount that each bears to the aggregate capital, surplus and borrowed money.

Adjustments Due to Changes in the Taxable Year. After the invested capital has been ascertained as at the beginning of the year certain adjustments may be necessary to ascertain the average invested capital during the year, which is the amount contemplated by the law.[145] The invested capital as of the beginning of any period of one year or less should be adjusted by an appropriate addition or deduction for each change in invested capital during the period. The amount so added or deducted in each case is the amount of the change averaged for the time remaining in the period during which it is in effect.[146] The fraction used in finding such average is the number of days remaining in the period (including the day on which the change occurs) over the number of days in the period. Thus, if a return is made for the calendar year ending December 31, 1918, and if $100,000 of additional capital was paid in on February 17, 1918, this addition to the invested capital is in effect for 318 days, and the amount to be added to the

144 Revenue Act of 1918, § 326 (c).

145 Revenue Act of 1918, § 326 (d).

146 The 1917 Law provided that the invested capital should be "averaged monthly" but the Treasury Department instead of adopting a monthly average required the invested capital to be averaged from the day on which the change took place. (See Form 1103 for 1917, Schedule D.) Under that law the following rules were made for ascertaining the average invested capital: (a) Add the capital for each of the several months during which no change occurs, and the average capital (ascertained as provided in subdivision (b) above) for each month in which a change occurs and divide the total by the number of months in the year or period. (b) To ascertain the capital for any month in which a change occurs multiply the capital as of the first day of the month by the number of days it remains constant and the capital after each change by the number of days (including the day on which the change occurs) during which it remains constant, add the products, and divide the sum by the number of days in the month. (Reg. 41, Art. 43.)

invested capital as of the beginning of the year would be 318/365 of $100,000 or $87,123.29. If $50,000 of this amount was withdrawn on October 31, 1918, the amount to be deducted would be 62/365 of $50,000, or $8,493.15.[147]

DIVIDENDS PAID FROM SURPLUS. The law expressly provides that any distribution of dividends made during the first sixty days of the year shall be deemed to have been made from the earnings or profits accumulated during the preceding taxable years.[148] A dividend other than a stock dividend affects the computation of invested capital from the date when the dividend is payable and not from the date when it is declared, except that where no date is set for its payment the date when declared will be considered also the date when payable. For the purpose of computing invested capital a dividend paid after the expiration of the first sixty days of the taxable year will be deemed to be paid out of the net income of the taxable year to the extent of the net income available for such purpose on the date when it is payable. The method of determining available net income is stated in the next paragraph. The surplus and undivided profits as of the beginning of the taxable year will be reduced as of the date when the dividend is payable by the entire amount of any dividend paid during the first sixty days of the taxable year and by the amount of any other dividend in excess of the current net income available for its payment. In the case of a dividend paid during the first sixty days of a taxable year which exceeds in amount the surplus and undivided profits as of the beginning of the taxable year the excess will be deemed to be paid out of earnings of the taxable year available at the date when the dividend is payable, and to the extent that such earnings are insufficient it will be deemed to be a liquidation of paid in capital or surplus. From the date when a dividend is payable the amount which the several stockholders are entitled to receive will be treated as if actually paid to them, whether or not it is so paid in fact, and the surplus and undivided profits, either of the taxable year or of the preceding years, will in accordance with the foregoing provisions be deemed to be reduced as of that date by the full amount of the dividend. Amounts paid to stockholders in anticipation of dividends, or amounts withdrawn by stockholders in excess of divi-

147 Reg. 45, Art. 853.

148 Revenue Act of 1918, § 201 (e).

dends declared, will in computing invested capital have the same effect as if actually paid as dividends.[149]

METHOD OF DETERMINING AVAILABLE NET INCOME. Whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment, or whether the surplus or undivided profits as of the beginning of the taxable year must be reduced by the amount of such payment, will be determined according to the following principles:

(1) The aggregate amount of earnings of the taxable year available for all purposes up to any given date will be determined upon the basis of the same proportion of the net income for the taxable year (as finally determined for the purpose of income and excess profits taxes) as the part of the year already elapsed is of the entire year, unless the corporation shows from its books or other records that a greater proportion of its earnings for the year was available on such date.

(2) The aggregate amount available will be deemed to be applied for the following purposes in the order in which they are stated: (a) accrued Federal income and war-profits and excess-profits taxes for the taxable year, and (b) dividends paid after the expiration of the first sixty days of the taxable year and other corporate purposes, including the purchase of outstanding stock of the corporation previously issued. In any case where the above computation would be indeterminate because of the effect of the provisions of this rule upon the invested capital for the year, the amount of such invested capital for the purpose of this computation may be deemed to be the invested capital as of the beginning of the taxable year, plus any additional capital paid in during such year and minus any specific withdrawal or liquidation of capital during such year.[150]

EFFECT OF STOCK DIVIDEND. The payment of a stock dividend has no effect upon the amount of invested capital. Such items as appraised value of good will, appreciation in value of real estate or other tangible property, etc., although carried to surplus and distributed as stock dividends, can not in this manner be capitalized and included in computing invested capital. If a corporation has paid a stock dividend in excess of its true surplus, it

[149] Reg. 45, Art. 858.
[150] Reg. 45, Art. 857.

can not be deemed to have any greater invested capital than could have been computed had no such stock dividend been paid.[151]

INCREASE OF CAPITAL STOCK. If the capital stock is increased during the taxable year, the invested capital will be considered to have been increased from and after the dates on which the cash or property for which such stock is issued are paid in.[152]

REDUCTION OF CAPITAL STOCK. If the capital stock is reduced during the year, the invested capital will be considered to be reduced accordingly from and after the dates on which the assets representing such reduction of capital stock are paid to the stockholders.[153] The mere reduction of the authorized capital without a distribution of the assets will not affect the invested capital.

PAYMENT OF PRECEDING YEAR'S EXCESS-PROFITS TAX. The amounts payable on account of income and excess-profits taxes for any year may be included in computing surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates upon which such taxes become due and payable.[154] The date when the 1918 taxes were *actually* paid has no bearing on the computation of the invested capital of a corporation for the year 1919, inasmuch as the controlling factor is the date when such taxes were due and payable, and not the date when they were actually paid. In other words, the amount of each installment of the tax for 1918 will remain a part of the invested capital for 1919 until such installment is due and payable, and when such installment is due, an adjustment should be made in the nature of a reduction of the book value of assets.[155] Income and excess-profits taxes are deemed to have been paid out of the net income for the taxable year for which such taxes are levied and it is immaterial whether or not a reserve was set up for such taxes and if set up, whether such taxes when paid have actually been charged against such reserves.[156] It seems immaterial whether or not sufficient earnings of the current

151 Reg. 45, Art. 859.

152 See p. 687.

153 See p. 687.

154 Reg. 45, Art. 845; T. D. 2791.

155 Letter from Treasury Department dated September 22, 1919; W. T. S. 1919, ¶ 1056.

156 Reg. 45, Art. 845; T. D. 2791.

year were on hand when such taxes were actually paid. In the case of corporations having a *fiscal* year, the Federal income and excess-profits taxes for the taxable year 1918 will, for the purpose of computing invested capital for the taxable year 1919, be deemed to become due and payable as follows: (a) As to such amounts as became due and payable prior to February 25, 1919, under the Revenue Act of 1916, such law shall govern; (b) In all other respects the Revenue Act of 1918 shall govern except that the installments which would become due prior to February 25, 1919, shall be deemed to become due and payable on that date; (c) Any amounts which became due and payable under the Revenue Act of 1916 prior to February 25, 1919, shall, so far as possible, be deemed to cancel the earlier installments payable under the Revenue Act of 1918.[157]

REDUCTION OF RESERVES. If payments are made out of any reserves set up on the books of the company, which reserves are in fact a part of the surplus and have been included as invested capital at the beginning of the year, the invested capital is not reduced by such payments, if the payments are such as may properly be charged against the net income for the current year under the law. Thus if a corporation is carrying a self-insurance reserve and sustains

157 T. D. 2931; Reg. 45, Art. 845 (a). See Revenue Act of 1918, § 250; Revenue Act of 1916, § 14 (a). Under the Revenue Act of 1916, in the case of a fiscal year corporation, return was due within 60 days after the close of the fiscal year and tax was due within 105 days after the last due date of the return (not after the date of filing), hence, for the fiscal year ended August 31, 1918, the return was due on or before October 30, 1918, and the tax on or before February 12, 1919, or on or before the 165th day after August 31, 1918. The provisions of this (Reg. 45, Art. 845 (a)) apply solely for the purpose of computing invested capital and do not affect the provisions of T. D. 2797 in regard to the time and manner of paying taxes where corporations have filed returns for fiscal years ending in 1918. The rule stated in the text is illustrated as follows: For example, a corporation whose fiscal year ended August 31, 1918, is assessed a total income and profits tax under the 1917 Law of $250,000 and an additional tax under the 1918 Law of $110,000. The total tax of $360,000 would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 12, 1919, $250,000; May 15, 1919, $20,000; August 15, 1919, $90,000. If, assuming the same taxes, the fiscal year ended September 30, 1918, the total tax would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 25, 1919, $90,000; March 15, 1919, $90,000; June 15, 1919, $90,000; September 15, 1919, $90,000. (See Letter from Treasury Department dated October 27, 1919; W. T. S. 1919, ¶ 1059.)

a loss in 1919 due to fire or other casualty, it may deduct that loss against the 1919 income although on its books the loss may be charged against the reserve. In such case the reserve is not reduced for purposes of invested capital. If, however, payment is made out of the reserves for any expenditure which is not deductible from the 1919 income and does not represent investment in a new asset the reserve is reduced for purposes of invested capital.[158]

Invested Capital for Fractional Part of Year. In the case of a corporation making a return for a full year of 12 months, its invested capital for the year is the average invested capital for the year. In the case of a corporation making a return for a fractional part of a year, its invested capital for such period is the same fractional part of the average invested capital for such period.[159] To illustrate: A corporation was organized July 1, 1918, and makes a return for the six months ending December 31, 1918. The invested capital consists of $100,000 paid in on July 1 and $100,000 paid in on October 1. The average invested capital for such period would be $100,000 plus 92/184 (not 92/365) of $100,000 or $50,000, a total of $150,000. The invested capital for the period for the purpose of the tax would, however, be 184/365 of $150,000, or $75,616.44.[160]

Invested Capital for Prewar Period. The invested capital for the prewar period should in general be determined in the same manner as for the taxable year.[161] The determination of invested capital for the prewar period is important for purposes of computing the war-profits credit.[162] Since the war-profits tax is only temporary, being in force for the year 1918, except in the case of corporations deriving a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and Novem-

158 See Reg. 45, Arts. 844 and 860.

159 For the purpose of § 311 (a) 2 of the statute it is the full average invested capital for the period.

160 Reg. 45, Arts. 855, 856. In computing the tax under a return for a fractional part of a period the same purpose may sometimes be more readily effected by using the full average invested capital and taking a fractional part of the result, as in schedule III of form 1120. In schedule IV of the same form, however, the fractional part of the full average invested capital for the period should be used.

161 Reg. 41, Art. 51; as to affiliated corporations see p. 708.

162 Revenue Act of 1918, § 311.

ber 11, 1918, both dates inclusive,[163] the following discussion of invested capital for the prewar period[164] relates only to the war-profits tax imposed on all corporations for the year 1918 and on corporations deriving income from government contracts, as above indicated,[165] for subsequent years.

ADJUSTMENT FOR ASSET DIFFERENTLY VALUED IN PREWAR INVESTED CAPITAL.[166] In any case in which as a result of a reorganization or for any other reason any asset in existence both during the taxable year and any prewar year is included in computing the invested capital for the taxable year, but is not included in computing the invested capital of such prewar year, or is valued on a different basis in computing the invested capital for the two years, the difference resulting therefrom may not be included in determining the difference, 10 per cent of which is added to or deducted from the war-profits credit. In any such case the corporation is required to make the readjustment required by the statute, and submit with its return a full statement of the difference in such valuations and of the facts which give rise to such difference.[167] This provision of the statute may operate in a case where a corporation was reorganized after the beginning of the prewar period, or consolidated with another, as a result of which good will, patents or other assets owned during the prewar period may have been capitalized for the first time, or the capital value of which may have been increased.

REORGANIZATION AFTER JANUARY 1, 1911. In the case of the reorganization, consolidation or change of ownership after January 1, 1911, of a trade or business carried on during the taxable year by a corporation, the corporation will, for the purpose of determining invested capital for the war-profits credit, be deemed to have been in existence prior to that date and the net income and invested capital of such predecessor for all or any part of the prewar period up to the organization of the corporation now carrying on such trade or business will be deemed to have been the net income and invested capital of such corporation. If the predecessor trade or business was carried on by a partnership

163 Revenue Act of 1918, § 301 (c).

164 See pp. 692-4, 695.

165 See pp. 649, 696 for further statement regarding this class of corporations.

166 The Revenue Act of 1917 was silent on this subject, and such adjustment was less important under that law.

167 Revenue Act of 1918, § 330; Reg. 45, Art. 934.

or individual, the corporation must make its return of the net income and invested capital of such trade or business as nearly as may be in the same manner as if such trade or business had been carried on by a corporation. It should submit with its return a statement setting forth (a) the manner in which such trade or business was carried on and (b) the points, if any, in which the provisions of the statute and of the regulations are not fully applicable to the determination of the net income or invested capital of the predecessor trade or business for the prewar period. In no case shall the deduction from gross income for salary or compensation for personal services exceed the salaries or compensation customarily paid at that time by corporations or partnerships of similar size and standing engaged in similar trades or businesses for similar services under like responsibilities.[168]

AVERAGE INVESTED CAPITAL FOR PREWAR PERIOD. The average invested capital for the prewar period is determined by first ascertaining the average invested capital for each year during the whole of which the corporation was in existence and averaging the sums so obtained.[169]

Invested Capital of Insurance Companies. The reserve funds of insurance companies the net additions to which are deductible from gross income[170] cannot be included in computing invested capital.[171]

Invested Capital of Foreign Corporations. Inasmuch as the war-profits and excess-profits tax in the case of a foreign corporation is not based on the invested capital of the corporation,

168 Revenue Act of 1918, § 330; Reg. 45, Art. 932.

169 Revenue Act of 1918, § 326 (d).

170 Revenue Act of 1918, § 234.

171 Revenue Act of 1918, §§ 325, 326 (b); Reg. 45, Arts. 870, 569, 814. Under the 1917 Law it was held that the invested capital of a mutual insurance company would be deemed to consist of the sum of (1) any surplus or contingent reserves maintained for the general use of the business, plus (2) any legal reserves the net additions to which are included in the net income subject to the tax, making due allowance for inadmissible assets as required by the law. The invested capital of a stock insurance company was deemed to consist of its capital stock, paid-in or earned surplus and undivided profits, subject to the restrictive provisions regarding inadmissible assets, and computed in accordance with the provisions applying to the computation of invested capital of corporations. (Reg. 41, Art. 65.)

but such corporations are assessed on the basis of representative corporations,[172] the rules for determining invested capital[173] have no application to foreign corporations. For the same reason, when rendering a return of income on form 1120 for a foreign corporation, no entry of invested capital should be made thereon.[174]

War-Profits Credit.[175] In the case of all domestic corporations the war-profits credit includes a specific exemption of $3,000.

MINIMUM WAR-PROFITS CREDIT. In all cases the minimum war-profits credit is an amount equal to 10% of the invested capital for the taxable year plus the specific exemption. This minimum exemption is allowed to any corporation which had no net income for the prewar period or whose net income for the prewar period was less than 10%.[176]

WHERE INCOME IN PREWAR PERIOD WAS MORE THAN 10%. If the net income of a corporation for the prewar period was more than 10%, the average net income, determined by taking the total net income for the prewar period and dividing by the number of years during the whole of which the corporation was in existence, even though there may have been no net income for one or more of such years, will be taken as a part of the war-profits credit. To this is added or deducted (depending upon whether or not the capital has been increased or reduced) 10%

172 See Revenue Act of 1918, §§ 327, 328.

173 Revenue Act of 1918, § 326; Reg. 45, Arts. 831-870.

174 Reg. 45, Arts. 871, 962. The 1917 Law provided that the invested capital of a foreign corporation would be determined by taking that proportion of the entire invested capital, as defined and limited by the law, which the net income from sources within the United States bore to the entire net income. (Revenue Act of 1917, § 207.) As a practical matter the Treasury Department found it extremely difficult to ascertain the invested capital of foreign corporations in this manner and ruled that where upon application by a foreign taxpayer it was found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income," assessment would be made under § 210 of that law (Reg. 41, Art. 52) as a case in which the invested capital could not be satisfactorily determined.

175 Revenue Act of 1918, § 311; Reg. 45, Arts. 781-785.

176 Reg. 45, Art. 782.

of the difference between the average invested capital for the prewar period and the invested capital for the taxable year.[177]

CORPORATIONS WHICH HAD NO PREWAR PERIOD. If the corporation had no prewar period, the war-profits credit is the specific exemption plus an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer (but not less than 10% of the invested capital of the taxpayer for the taxable year). Such average percentage is to be determined by the Commissioner on the basis of data contained in the excess-profits tax returns filed under the Revenue Act of 1917. As such average percentage had not been determined and published at least thirty days prior to the time when the 1918 return of the taxpayer was due, such return was made up by using 10% as a deduction, but such average percentage when determined is to be used by the Commissioner in fixing the correct amount of the tax.[178] The average percentages of prewar income to prewar invested capital of general classes of corporations, grouped as to trades or businesses has now been published and is known as the "Median."[179] If the majority of the stock of any corporation which had no prewar period is owned or controlled at any time during the taxable year by a corporation which had a prewar period, this provision does not apply and the war-profits credit will consist of the sum of the specific exemption of $3,000 and an amount equal to 10% of the corporation's invested capital for the taxable year.[180]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. In the case of a corporation which had no prewar period and 50% or more of whose gross income consists of gains, profits, commissions, or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the war-profits credit will consist of the sum of the specific ex-

177 Reg. 45, Art. 781; See illustration No. 1, Appendix.

178 Revenue Act of 1918, § 311 (c).

179 See the Appendix. The average known as the medium is by the statute required to be used. It is not an arithmetic average but is found by taking the middle figure of a series or array of figures arranged in order from the lowest to the highest.

180 Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784.

emption and an amount equal to 10% of the invested capital for the taxable year.[181]

APPORTIONMENT OF WAR-PROFITS CREDIT IN CASE OF CORPORATION REPORTING FOR PART OF YEAR. If a return is made, for a period of less than twelve months, the amount equal to the average net income for the prewar period plus or minus 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year will be reduced to the same proportion thereof as the number of months in the period is of twelve months.[182]

Excess-Profits Credit. The excess-profits credit in the case of a domestic corporation consists of the specific exemption of $3,000 plus an amount equal to 8% of the invested capital for the taxable year.[183]

Specific Exemption. Domestic corporations are allowed a specific exemption of $3,000 to be deducted from the net income, but if the tax is computed for a period of less than twelve months the specific exemption is reduced in proportion.[184] The specific exemption of $3,000 is apportioned only in the case where a return is made covering a period of less than twelve months. In such a case the specific exemption is the same proportion of $3,000 as the number of months in the period is of twelve months, any fractional part of a month being counted as the number of days in such part of a month divided by 30. Thus, in the case of a corporation organized May 12, 1918, and making a return for the period ending December 31, 1918, the exemption is $1,916.67, that is, the same proportion of $3,000 as 7 20/30 months is of 12 months. This provision is inapplicable where the return is made for a full fiscal year beginning prior to January 1, 1918, and ending after that date, even though the income for such fiscal year is not subject to full taxation under

181 Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784. It should be noted that this provision applies to all corporations which had no pre-war period and one-half of whose income is derived from Government contracts or subcontracts (as defined in § 1 of the 1918 law—see p. 648. In § 327 of the law, the restriction is limited to cases where the Government contracts provided for payment on a cost-plus basis. See p. 699.

182 Reg. 45, Art. 781. The same result is reached in schedule IV of return form 1120 by computing the war-profits credit for a full year and taking a fractional part of the result.

183 Revenue Act of 1918, § 312; Reg. 45, Art. 791.

184 Revenue Act of 1918, § 305.

the present statute. In the case of affiliated corporations only one specific exemption is allowed.[185]

Net Income. Net income for this tax is ascertained in general upon the same basis and in the same manner as for the purpose of the income tax except as noted below. Reference to the rules for estimating income for the prewar period is given as well as the rules applying to the taxable year. Under the excess-profits tax, however, no attention need be paid to income during the prewar period but the rules for that period are given because they still apply to such corporations as by reason of deriving income from Government contracts of the kind hereinbefore indicated continue to be subject to the war-profits tax if their income from such contracts exceeds the sum of $10,000 in the taxable year.

For the Years 1911 and 1912. The net income for these years is determined upon the same basis and in the same manner as provided in the 1909 Corporation Excise Tax Law except that the tax as imposed by that law and paid by the corporation within the year shall be included.[186] Including such taxes for the years 1911 and 1912 is a slight advantage to the corporation in that it increases the net income for the prewar period for the purpose of the war-profits credit.

For the Year 1913. The net income for the year 1913 is ascertained on the same basis and in the same manner as provided in the 1913 Law except that the taxes imposed by the 1909 Corporation Excise Tax Law on the corporation on its income for 1912 and paid by the corporation in 1913 may be included, and amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by the 1913 Law, must be deducted.[187]

Average Net Income for the Prewar Period. The average net income for the prewar period is determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.[188] Thus, if a corporation was in

185 Reg. 45, Art. 761. On return form 1120 this apportionment is taken care of by prorating items 3 and 8 of schedule III.

186 Revenue Act of 1918, § 320 (a) 1; Reg. 45, Art. 801.

187 Revenue Act of 1918, § 320 (a) 2; Reg. 45, Art. 801.

188 Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1017.

existence during 1912 and 1913 but derived no income in 1912, its income for the year 1913 must be divided by two in order to ascertain the war-profits credit. But, on the other hand, if the corporation had a deficit for the year 1912 and income for the year 1913, the amount of the deficit need not be deducted from the net income of 1913 in order to ascertain the average net income for the prewar period.[189]

FOR THE TAXABLE YEAR. Net income for the taxable year is computed upon the same basis and in the same manner as provided for income tax purposes under the income tax law.[190] The law expressly provides that the net income of a corporation which is subject to the income tax shall also be subject to the excess-profits tax. This would include income derived from the sales or dealings in the capital assets of the taxpayer,[191] but in the case of the sale of mines, oil and gas wells a limitation is placed upon the amount of the excess-profits tax to be assessed with respect thereto.[192]

Assessment Without Reference to Invested Capital. In certain cases it is found difficult or impossible to determine the invested capital of a corporation. In such cases and in cases of "abnormal conditions affecting the capital or income of a corporation," without reference to the difficulty or impossibility of determining invested capital in the ordinary manner, the excess-profits tax will be computed on the basis of the returns of representative cor-

189 Letter from Treasury Department dated February 21, 1918. As to the prewar income of affiliated corporations, see p. 711.

190 Revenue Act of 1918, § 320 (a).

191 Letter from Treasury Department dated February 21, 1918.

192 See p. 655. Under the 1917 Law the net income for purpose of income tax and excess-profits tax were not identical, since for the purpose of the latter tax corporations were expressly allowed to deduct dividends. Since the 1917 Law provided an excess-profits tax at lower rates on salaries than on income from a business employing invested capital, the Treasury Department held that where a corporation had paid its officers only nominal salaries, a reasonable allowance for salaries could be deducted for any period prior to March 1, 1918, if a satisfactory explanation was given. (Letter from Treasury Department dated March 11, 1918.) Under the present law there seems to be no need for a ruling of this character since an excess-profits tax law has been in force for a length of time sufficient to enable corporations to adjust salaries and other items which in the past may have been merely nominal by reason of the relation of the corporation to its stockholders.

porations engaged in a like or similar trade or business.[193] Four cases in which the tax will be so determined are enumerated in the law and are discussed in the following paragraphs.

Where Commissioner Is Unable to Determine Invested Capital. The first case is where the Commissioner is unable to determine invested capital as defined in the law. Such cases exist, for example, where the books of account of the company have not been kept in proper form or where it is impossible to ascertain the values of assets at the time of acquisition.[194]

In the Case of Foreign Corporations. The Revenue Act of 1918 provides that, in the case of foreign corporations, the tax shall be determined without reference to invested capital as defined in the law.[195] In the case of a foreign corporation carrying on all of its business in the United States it does not seem that the law should prevent the corporation from obtaining such benefits as may accrue to it from a computation of the credits with reference to an invested capital determined in the ordinary manner, but the language of the provision that the tax shall be assessed by reference to representative corporations indicates an intent that

193 Revenue Act of 1918, § 327. This section of the 1918 Law corresponds to the famous Section 210 of the 1917 Law which provided that when the invested capital could not be satisfactorily determined the corporation was entitled to an excess-profits deduction of an amount equal to the same proportion of its net income for the taxable year as the proportion which the average deduction (excluding the specific sum of $3,000) for the corresponding year of representative corporations bears to the total income of such representative corporations plus, in the case of domestic corporations, the sum of $3,000. This section applied also to partnerships and individuals under the 1917 Law. In determining this proportion the net incomes of representative corporations for the calendar year or for fiscal years ending in the calendar year were taken. In case the corporation whose invested capital could not be satisfactorily determined made a return for its own fiscal year the proportion determined for the calendar year ending during such fiscal year was used. (Reg. 41, Art. 24.) The rulings provided for a computation of constructive invested capital in order to apply the rates to a corporation whose invested capital could not be determined. (Reg. 41, Art. 18.) *Under the present law there is no need for constructive capital in such cases since the tax is now based upon the ratio of the amount of tax to the amount of net income of representative corporations.*

194 Revenue Act of 1918, § 327 (a). The 1917 Law (Section 210) provided a method which should be followed in all cases in which the Commissioner was unable *satisfactorily* to determine the invested capital. In the language of the present law the word "satisfactorily" was omitted.

195 Revenue Act of 1918, Sec. 326.

this method of assessment shall apply to all foreign corporations, and the Treasury Department has so ruled.[196]

Where Stock Has Been Issued for a Mixed Aggregate of Tangible and Intangible Property. The provision of the law that the tax shall be assessed by reference to representative corporations where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds, does not apply in all cases where a mixed aggregate of tangible and intangible property has been paid in for stock or for stock and bonds, but only in such cases where the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively.[197]

Cases of Abnormal Conditions Affecting Capital or Income. In cases of abnormal conditions affecting the capital or income of a corporation, assessment without reference to invested capital is intended to operate as a remedial measure as distinguished from cases where it is difficult or impossible to determine invested capital. Such assessment is made only upon application by the corporation in cases where, upon such application, the Commissioner finds (and so declares of record) that the tax if determined without the benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without the benefit of this section and the tax computed by reference to representative corporations. This provision does not apply to any case (1) in which the tax based upon the corporation's invested capital is high merely because the corporation earned a high rate of profit upon a normal invested capital nor (2) in which 50% or more of the gross income of the corporation for the taxable year consists of gains, profits, commissions or other income derived *on a cost plus basis* from a Government

196 Revenue Act of 1918, § 327; Reg. 45, Art. 871.

197 Revenue Act of 1918, § 327 (c). Under the 1917 Law it was ruled that assessment would be made under section 210 of that law in cases where the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment. (Reg. 41, Art. 52.) This provision of the law seems to be a statutory declaration of the rule adopted by the Treasury Department as a matter of practice.

contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[198] The tax will not ordinarily be assessed under this provision of law merely because the corporation's form or manner of organization, or the limitations as to invested capital result in a greater tax than would otherwise be payable. Referring to the legislative history of the Revenue Act of 1918, it will be noted that this provision of the statute as enacted by the Senate read as follows: "(e) Where the invested capital is materially disproportionate to the net income as compared with representative corporations engaged in a like or similar trade or business because: 1. The capital employed, although a material income-producing factor, is very small or is in large part borrowed. 2. There are excluded from the invested capital as computed under the provisions of section 326, intangible assets of recognized and substantial value built up or developed by the taxpayer. 3. The net income for the tax-

198 Revenue Act of 1918, § 328 (d). Under the 1917 Law the following were held to be exceptional cases which warranted assessment under Section 210 of that law.

(1) Where, through defective accounting or lack of adequate data, it was impossible accurately to compute invested capital.

(2) Where upon application by a foreign taxpayer the Secretary of the Treasury found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income."

(3) Long established business concerns which by reason of ultra-conservative accounting or the form and manner of their organization would otherwise be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.

(4) Where the invested capital was seriously disproportionate to the taxable income. Such cases it was held might arise through (a) the realization in one year of the earnings of capital unproductively invested during a period of years or the fruits of activities antedating the taxable year; or (b) inability to recognize or properly allow for amortization, obsolescence, or exceptional depreciation due to the war, or to the necessity in connection with the war of providing plant which would not be wanted for the purposes of the business after the termination of the war. (Reg. 41, Art. 52.)

Under the present law the conditions described in 1 and 2 are expressly provided for; 3 and 4 (a) will probably be considered as creating "abnormal conditions affecting the capital or income" within the meaning of Section 327 (d) and therefore entitle the corporation to relief. The condition stated in 4 (b) no longer exists as the present law enables the taxpayer to recognize and properly allow for amortization, obsolescence or exceptional depreciation.

able year is abnormally high due to the realization in one year of (a) gains, profits, or income earned or accrued during a period of years or (b) extraordinary gains or profit derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer. When the tax is determined under this paragraph proper allowance shall be made for the taxes which would have been payable in prior years if the gains, profits, or income earned or accrued in such years had been taxed at the rates then applicable. 4. Proper recognition or allowance can not be made for amortization, obsolescence, or exceptional depletion due to the present war, or to the necessity in connection with the present war of providing plant which will not be wanted for the purpose of the trade or business after the termination of the war." This provision was stricken out by the Conference Committee and in its place is inserted the vague phrase "abnormal conditions affecting the capital or income of a corporation."[199] It seems probable that the instances enumerated in the Senate bill as above quoted are contemplated by the phrase of the law as finally passed—abnormal conditions affecting the capital or income of the corporation—and that the Conference Committee used the broad language enacted in the statute as finally passed because of the possibility that in defining the operation of the provisions for assessment of the excess-profits tax by reference to representative corporations it would be limiting the Commissioner in the exercise of his discretion and possibly preventing him from granting relief in many cases which could not be exactly anticipated or defined by Congress at the time the law was enacted. It is a well-established principle of statutory construction that where the language of the statute is ambiguous and its meaning doubtful, the bill as introduced and changes made in the frame of the bill in the course of its passage may be resorted to upon questions of legislative intent.[200] The above language of the Senate bill should be consulted in connection with applications for relief by way of assessment with reference to repre-

199 This provision was in large a statutory enactment of the Treasury Department's previous liberal construction of Section 210 of the Revenue Act of 1917. Compare the provision with the regulation quoted in Note 198.

200 U. S. v. St. Paul M. MR. Co. 247, U. S. 310, 318; Atl. C. L. R. Co. v. Riverside Mills 219, U. S. 196, 200. See also cases cited in chapter 47.

sentative corporations. A corporation the income or capital of which is affected by abnormal conditions may make application for assessment by reference to representative corporations, which application should be attached to its return in the form of a statement setting forth in full: (a) the reasons why the tax should be so determined; (b) the facts upon which such reasons are based; (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions or other income derived on a cost plus basis from Government contracts made after April 5, 1917, and before November 12, 1918, and showing the percentage which such income is of the total income of the corporation.[201]

Method of Assessment. Under the method of assessment by reference to representative corporations the tax will be an amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax is computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.[202] Illustrations: If the average net income of representative corporations is represented by $100,000, the net income in excess of the specific exemption would be $97,000. If the average tax is found to be $38,800, the rate to be applied to domestic corporations will be 38,800 ÷ 97,000 or 40%. Thus, a domestic corporation having a net income of $60,000 will deduct the specific exemption of $3,000, leaving $57,000—40% of which is $22,800, the amount of tax due under this section. But if the corporation is a foreign corporation and has an income of $60,000 the tax rate will be determined by dividing 38,800 by 100,000 which decreases the percentage to 38.8%. But this is applied to the entire net income, $60,000, making the tax due from

[201] Reg. 45, Art. 901.

[202] Revenue Act of 1918, § 328 (a). This method is much simpler than that prescribed by Section 210 of the 1917 Law and reaches approximately the same result.

the foreign corporation $23,280, or $480 more than that imposed on a domestic corporation with the same net income.

Representative Corporations. The representative corporations with respect to which the tax is to be computed under this section are those corporations whose invested capital can be satisfactorily determined in the ordinary manner and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war-profits or excess-profits, and all other relevant facts and circumstances.[203] In each case the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared.[204]

Ratio Between Average Tax and Average Net Income. The ratio between the average tax and the average net income of representative corporations is to be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.[205]

Payment of Tax by Corporations Applying for This Assessment. In cases in which the tax is to be computed without reference to the invested capital, the corporation is required to pay its tax in installments without the benefit of the section, if the tax as so computed is less than 50% of the net income of the taxpayer. But if the tax so computed is 50% or more of the net income the installments to be paid by the corporation must be computed in the first instance upon the basis of a tax equal to 50% of the net income. The installments of the tax are provisionally computed as provided in the following paragraphs. These installments are paid until the commission notifies the corporation the amount of tax as computed without reference to invested capital. In any

[203] Revenue Act of 1918, § 328 (a).

[204] Reg. 45, Art. 911. It seems that the following should be considered in selecting representative corporations: (1) a representative corporation should be fairly representative of all corporations engaged in the same general line of business, as that of the corporation seeking the assessment under this provision of the law; (2) it should operate in the same general vicinity: (3) it should approximate in gross sales, gross earnings, and net earnings; (4) it should approximate as to manner and form of organization, especially financing; and (5) it should have been in business for approximately the same length of time.

[205] Revenue Act of 1918, § 328 (b).

case, the actual ratio when ascertained will be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50% of the net income any excess of the correct installments over the amounts actually paid will become due and payable ten days after notice and demand together with interest at the rate of one-half of one per cent. per month on such excess from the time the installment was due. If, on the other hand, the correct determination of the amount of the tax is less than the amount on which installments have been paid the law impliedly provides that the amount so paid shall either be credited to the installments falling due after final determination, or if all the installments have been paid before the tax is finally determined the amount shall be refunded in the usual manner.[206] No interest however will be paid to the taxpayer on excess amounts paid in the first instance. The Treasury Department requires every corporation of this class which pays a tax based on 50% of its net income, although the tax computed on the basis of its invested capital is greater, to file a claim for abatement on Form 47 for the excess over 50% of its net income.[207] The filing of such claim appears to be required for the purpose of observing the routine of the Treasury Department.

Determination of First Installment of Tax in Special Cases. In the case of any corporation, other than a foreign corporation, where absolutely no data are available for the determination of the invested capital for the taxable year, the installments of the tax will be determined in the first instance upon the basis of a war-profits and excess-profits tax equal to 50% of the net income. In any other case in which application is made for assessment by reference to representative corporations, other than the case of a foreign corporation, but including a case where the invested capital for the taxable year can not be accurately determined, but where a minimum amount of invested capital as to which there is no question can be determined, the installments will be determined in the first instance upon the basis of a war-profits and excess-profits tax computed by using the minimum invested capital, such tax not to exceed an amount equal to 50% of the net income.[208]

[206] Revenue Act of 1918, § 328; Reg. 45, Art. 914.

[207] Letter from Treasury Department dated October 15, 1919; W. T. S. 1919, ¶ 1058.

[208] Reg. 45, Art. 912.

Determination of First Installment of Tax in the Case of Foreign Corporation. In the case of a foreign corporation the installments of the tax will be determined in the first instance upon the basis of a war-profits and excess-profits tax computed by using its invested capital for the taxable year 1917, such tax not to exceed an amount equal to 50% of the net income. For this purpose the invested capital for 1917 will be adjusted for any subsequent changes in its amount, due to cash or property paid in or withdrawn or to surplus or undivided profits of prior years retained in the business and properly attributable to its business within the United States. If the tax for 1917 was determined by assessment with reference to representative corporations, the constructive capital which would result in a tax equivalent to the tax so determined will be used.[209]

Commissioner to Keep Record. The Commissioner is required to keep a record of all cases in which the tax is determined without reference to invested capital containing the name and address of the taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return.[210] The Commissioner is required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions usually imposed upon him with respect to divulging information contained in income tax returns.[211]

Incorporation of Business of Partnership or Individual. In the case of the organization as a corporation before July 1, 1919, of any business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation for income tax, excess-profits and war-profits tax purposes. If the individual or partnership chooses to adopt this method of taxation the net income and invested capital must be computed

209 Reg. 45, Art. 913.

210 The law also requires this record to show the amount of invested capital as determined under subdivision (a) of Section 328, but that subdivision does not call for a determination of invested capital and hence this requirement is meaningless.

211 Revenue Act of 1918, § 328 (c).

as if the corporation had been in existence on and after January 1, 1918, and in such cases, (1) amounts distributed on or after January 1, 1918, from the earnings will be taxed to the recipients as dividends; (2) all the provisions of the income tax and the war-profits and excess-profits tax sections of the law relating to corporations will so far as practicable be applied to such trade or business; (3) the trade or business will be subject to the capital stock tax imposed by Section 407 of the Revenue Act of 1917 and Section 1000 of the Revenue Act of 1918, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value; (4) the undistributed profits or earnings of such taxpayer will not be subject to the surtax. The adoption of any other date than January 1, 1918, for such purpose is not permissible. This option to be taxed as a corporation does not apply to any trade or business the net income of which for the taxable year 1918 was less than 20% of its invested capital for such year.[212]

Affiliated Corporations. The invested capital of affiliated corporations[213] for the taxable year is the invested capital of the entire group treated as one unit operated under a common control. As a first step in the computation a consolidated balance sheet should be prepared in accordance with standard accounting practices, which will reflect the actual assets and liabilities of the affiliated group. In preparing such a balance sheet all intercompany items, such as intercompany notes and accounts receivable and payable, should be eliminated from the assets and the liabilities, respectively, and proper adjustments should be made in respect of intercompany profits or losses reflected in inventories which at the beginning or end of the taxable year contain merchandise exchanged between the corporations included in the affiliated group at prices above or below cost to the producing or original owner corporation. Such consolidated balance sheet will then show (a) the capital stock of the parent or principal company in the hands of the public; (b) the consolidated surplus belonging to the stockholders of the parent or principal company; and (c) the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest. In computing consolidated invested capital the

212 Revenue Act of 1918, § 330; Reg. 45, Art. 933.
213 See p. 162.

starting point is furnished by the total of the amounts shown under (a), (b) and (c) above. This total must be increased or diminished by any adjustments required to be made under the provisions relating to invested capital.[214]

INTANGIBLE PROPERTY PAID IN. The following rules govern the inclusion of intangible property in invested capital of affiliated corporations: (1) In respect of corporations whose affiliation is in the nature of parent and subsidiary companies: (a) in the case of intangible property *bona fide* paid in for stock or shares prior to March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent of the par value of the total stock or shares of the consolidation outstanding on March 3, 1917 (determined as indicated in items (a) and (c) of the preceding paragraph), or in the aggregate 25 per cent of the par value of the total stock or shares shown on the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph, at the beginning of the taxable year, whichever is lowest; and (b) in the case of intangible property *bona fide* paid in for stock or shares on or after March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in, or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent of the par value of the total stock or shares shown by the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph outstanding at the beginning of the taxable year, whichever is lowest. (c) When intangible property has been acquired in part before and in part after March 3, 1917, the amounts shall be ascertained, respectively, under (a) and (b) above and in the aggregate shall in no case exceed 25 per cent of the par value of the total stock or shares outstanding at the beginning of the taxable year shown in the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph. (2) In respect of corporations affiliated by reason of ownership by the same interests, the limitations with respect to the inclusion of intangible property in invested capital set forth in paragraphs (4) and

214 Reg. 45, Art. 864.

(5) of subdivision (a) of Section 326 of the statute shall be applied to each corporation separately and the aggregate of the intangible property, so valued, shall be included in invested capital in the consolidated return. In respect of each of the affiliated corporations the aggregate of the amounts ascertained under the provisions of paragraphs (4) and (5) shall in no case exceed 25 per cent of the outstanding capital stock of such corporation at the beginning of the taxable year.[215]

INADMISSIBLE ASSETS. Where adjustment is required in respect of inadmissible assets, such adjustment must be made on the basis of the consolidated balance sheet with due regard to the adjustments and eliminations set forth in the preceding paragraphs and the general provisions relating to inadmissible assets.[216]

STOCK OF SUBSIDIARY ACQUIRED FOR CASH. When all or substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid will be the basis to be used in determining the value of the property acquired.[217]

STOCK OF SUBSIDIARY ACQUIRED FOR STOCK. Where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect of the company acquired will be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim must be supported by substantially the same sort of evidence as is required in the case of a claim for paid-in surplus in respect of tangible property paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor.[218]

INVESTED CAPITAL FOR PREWAR PERIOD. The invested capital of affiliated corporations for the prewar period will be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations included in the consolidation for the taxable year were in existence dur-

215 Reg. 45, Art. 865.

216 Reg. 45, Art. 866.

217 Reg. 45, Art. 867; T. D. 2901, modifying T. D. 2662.

218 Reg. 45, Art. 868; T. D. 2901, modifying T. D. 2662. See also Reg. 45, Art. 837

ing the prewar period, but were not then affiliated, then the average consolidated invested capital for the prewar period will be the average invested capital of the corporations which were affiliated in the prewar period plus the aggregate of the average invested capital for each of the several corporations which were not affiliated during the prewar period.[219]

PREWAR NET INCOME OF AFFILIATED CORPORATIONS. The consolidated net income of affiliated corporations for the prewar period will be the average consolidated net income for the prewar years of such of the several corporations included in the consolidation for the taxable year as were affiliated during the prewar period plus the aggregate of the average net income for each of the corporations not affiliated during the prewar period which were in existence during all of the prewar period or during at least one full year within the prewar period. The net income of a subsidiary corporation organized during the prewar period by an existing corporation should also be included.[220]

Balance Sheet. Every corporation is required to submit a balance sheet as of the first day of the taxable year and also a balance sheet as of the close of the taxable year. Balance sheets are required to be made in accordance with the books of the taxpayer and changes in respect of any items therein made pursuant to the regulations are to be explained in a separate statement attached to the balance sheet to which it relates.[221]

Returns. Every corporation not expressly exempt from tax and every personal service corporation must make a return regardless of the amount of its net income.[222] Corporations which have no taxable income for the year are required to fill out only Schedules A and B of Form 1120, which relate to the income tax, and the schedules in support thereof, and are not required to furnish the other information called for by this form.[223] Excess-profits

219 Reg. 45, Art. 869. See p. 692. Full recognition, however, must be given to the provisions of Section 330 of the statute, particularly the last paragraph thereof, and of articles 931-934, Reg. 45.

220 Reg. 45, Art. 802.

221 Reg. 41, Art. 53. As to the preparation of consolidated balance sheets, see p. 168.

222 Reg. 45, Art. 621.

223 Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1016.

tax returns are now a part of the income tax returns of corporations, and are governed by the same rules as to time, place, and manner of filing.

RETURNS IN SPECIAL CASES. Where a corporation computes its war-profits credit upon the basis of the sum of (a) the specific exemption and (b) an amount equal to 10 per cent of the invested capital for the taxable year, the items on form 1120 which relate solely to the net income or to the invested capital for the prewar period need not be filled in.[294] Where a corporation enters on its return a war-profits and excess-profits tax equal to the amount of the maximum tax, the items on form 1120 which relate solely to the net income for the prewar period and the items which relate to the invested capital for the prewar period and for the taxable year need not be filled in. Likewise in the case of a foreign corporation the same items may be disregarded, except that all of schedule I on form 1120 should be filled in and balance sheets as of the beginning and the end of the taxable year for the entire business of the corporation both within and without the United States should be submitted. Corporations which have no taxable income for the year are required to fill out only schedules A and B and the schedules in support thereof on their (separate or consolidated) returns (Form 1120) and are not required to furnish the other information called for by these returns.[295] The Commissioner may at any time specifically call for all or any part of the information which is not so required to be entered on the return. In any case, however, where a claim is made for assessment by reference to representative corporations other than in the case of a foreign corporation, the corporation should fill out all items of the return so far as possible and submit a statement explaining why it is impracticable to fill out the entire return.[296]

Time and Manner of Paying Tax. The war-profits and excess-profits taxes are to be paid at the same times and places, in the

294 Telegram from Treasury Department dated April 10, 1919; W. T. S. 1919, ¶ 1022. Under the 1917 Law it was held that a return of information as to invested capital and net income for the prewar period would not be required if the taxpayer accepted the minimum percentage of 7% as a deduction.

295 Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1076.

296 Reg. 45, Art. 962.

same manner, and subject to the same conditions, as provided in the case of payments of income tax; that is the tax will be paid in installments on the dates specified with reference to the income tax.[227]

Penalties. All the provisions of the income tax law not inapplicable, including the provisions relating to penalties, are made applicable to the filing of returns and payment of war-profits and excess-profits taxes.[228]

Administrative Provisions. In general, the administrative provisions applicable to the income tax law are also applicable to the administration of the war-profits and excess-profits tax law.[229]

227 Revenue Act of 1918, § 336. As to the time and manner of paying income taxes see Chapter 35.

228 Revenue Act of 1918, § 336.

229 Revenue Act of 1918, § 336.

CHAPTER 44

THE CAPITAL STOCK TAX

This tax is popularly known as the Capital Stock Tax, although the statute describes it as "a special excise tax with respect to carrying on or doing business." The present law[1] describes the tax in the same manner as did the 1916 Law[2] and imposes a tax on and after July 1, 1918, in lieu of the tax imposed by the 1916 Law. The tax is imposed upon every domestic[3] corporation[4] and upon every foreign[5] corporation doing business in the United States. The Revenue Act of 1918 in imposing this tax, does not, like the 1916 Law, limit the corporations taxed to those organized "for profit" and apparently applies to every corporation having capital stock whether organized for profit or not, except those exempt from income tax under Section 231 of the Revenue Act of 1918.[6] The tax is imposed "with respect to carrying on or doing business" and is payable in advance by every taxable corporation engaged in business during any part of the preceding year.

Definitions. The word "corporation" is used in this chapter, unless otherwise stated, in the sense defined in the Revenue Act of 1918, and includes a corporation, association, joint-stock company, or insurance company.[7] The phrase "taxable year" as

1 Revenue Act of 1918, § 1000.

2 Act of September 8, 1916, § 407.

3 The term "domestic" when applied to a corporation, means "created or organized in the United States," (Revenue Act of 1918, § 1), including only the states, the territories of Alaska and Hawaii, and the District of Columbia. (Reg. 50, Art. 11.)

4 The term "corporation" includes "associations, joint-stock companies and insurance companies." (Revenue Act of 1918, § 1.)

5 The term "foreign," when applied to a corporation, means created or organized outside the United States. (Revenue Act of 1918, § 1.)

6 Revenue Act of 1918, § 1000. The 1916 Law provided expressly that corporations exempt under the provisions of Section 11 of the 1916 income tax law were also exempt for purpose of the capital stock tax.

7 Revenue Act of 1918, § 1; Reg. 50, Art. 11.

used in this chapter means the fiscal year of the Government beginning on the first day of July of each calendar year and ending on the last day of June the year following. The phrases "preceding year" and "preceding taxable year" mean the twelve-month period ending immediately prior to the "taxable year" as above defined.

Domestic Corporations. The tax applies to a domestic corporation if (a) it is carrying on or doing business; (b) has capital stock; (c) was engaged in business for some part of the preceding year ending June 30th, and (d) is not one of the corporations enumerated as exempt for purpose of income tax. The 1916 Law provided that the corporation should be organized for profit and have a capital stock represented by shares. In this respect the 1918 Law is broader in its scope and a corporation is liable to the tax whether it is a creature of statute or of contract and whether or not it is organized for profit or has a capital stock represented by shares.[8]

ASSOCIATIONS. It should be noted that the law applies not only to corporations but also to all associations "organized in the United States" and in this respect seems to be broader in its scope than the 1909 Law, which was construed to apply only to corporations, joint-stock companies or associations "organized under the laws of the United States or of any State or Territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia."[9] Apparently it was the intent of Congress to make the present as well as the former capital stock tax law apply to associations which were held not to be taxable under the 1909 Law, because not organized under some statute. The Treasury Department has ruled that associations and joint-stock companies include associations, common law trusts and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to

[8] Reg. 50, Art. 11.

[9] It was the intention of Congress to embrace within the 1909 Law only such corporations and joint-stock associations as were organized under some statute or derived from that source some quality or benefit not existing at the common law. (Eliot v. Freeman, 220 U. S. 178.) This was a case involving a so-called "Massachusetts Real Estate Trust" which was held not to be taxable under the 1909 Law but which would seem to be taxable under the capital stock tax law.

State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization.[10]

Association Distinguished From Partnership. An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership.[11]

Association Distinguished From Trust. Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists. If, however, the *cestuis que trust* have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.[12]

Limited Partnership as Partnership. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which cannot limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which

10 Reg. 50, Art. 12.

11 Reg. 50, Art. 13.

12 Reg. 50, Art. 14. See Crocker v. Malley, 249 U. S. 223.

can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership.[13]

LIMITED PARTNERSHIP AS CORPORATION. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. Michigan partnership associations are corporations. Such a corporation may or may not be a personal service corporation.[14] A personal service corporation is liable for the capital stock tax notwithstanding that it reports as a partnership for purpose of the income and excess-profits taxes.

Foreign Corporations. A foreign corporation is taxable if it (a) is "carrying on or doing business in the United States" during the taxable year; (b) was engaged in business in the United States during some part of the preceding year ending June 30th; (c) is not one of the corporations enumerated in Section 231 of the law as exempt from income tax, and (d) has capital employed in the transaction of its business in the United States.[15] It is to be noted that a foreign corporation is not subject to this tax merely because it receives income from sources within this country. To be taxable, a foreign corporation must be carrying on or doing business in the United States and must have capital employed in the transaction of such business. The chapter on foreign corporations, in the foregoing part of this book, contains decisions and rulings which define what is "doing business" by foreign corporations, and such decisions and rul-

13 Reg. 50, Art. 15.
14 Reg. 50, Art. 16.
15 Revenue Act of 1918, § 1000.

ings have application to this tax. It should be borne in mind, however, that some of the rulings with respect to the taxability of foreign corporations under the income tax law have no application to this law, since this tax is imposed only when the foreign corporation is carrying on or doing business in this country and has capital employed in the transaction of such business.[16]

Basis and Rate of Tax. The basis of the capital stock tax differs accordingly as the taxable corporation is domestic or foreign or is an insurance company.

Domestic Corporations. The basis of the tax in the case of all domestic corporations is "the fair average value of its capital stock for the preceding year ending June 30th." No deduction is allowed by reason of the fact that a part of the capital stock may be represented by assets in foreign countries or that a part of the capital may be invested in business and a part may not. The rate of tax is $1 for each full $1,000 of the fair average value of the capital stock in excess of the prescribed deduction. The tax is not upon the par value of the capital stock but upon its fair average value for the preceding year ending June 30. It is on an entirely different basis from the excess-profits tax which is concerned with invested capital, and not with the present fair value of the capital. The fair value of the entire capital stock of a corporation is not necessarily the product of the market value of each share multiplied by the number of shares. Stock in the treasury of a corporation is not regarded as outstanding, unless pledged as security for a debt. No deduction is allowed corporations organized in the United States for capital invested outside the United States. If a corporation is doing any business it is taxed on its entire capital, even though most of it may not be employed in the business.[17] From the total fair average value of the capital stock, the sum of $5,000 is deductible, and the tax is upon each full $1,000 of any balance. Accordingly, corporations the fair value of whose capital stock is not more than $5,000 are not subject to any tax. However, for the purpose of avoiding errors, *every* corporation must file a return, even though the par

16 Laurentide Co., Ltd., v. Durey, 231 Fed. 223, and Bryant & May, Ltd. v. Scott, 226 Fed. 875 are cases in point. See p. 195.

17 Reg. 50, Art. 22.

value or the fair average value of its capital stock does not exceed $5,000.[18]

Fair Average Value of Capital Stock. The law provides that the surplus and undivided profits must be included in estimating the fair average value of the capital stock; that is to say, the capital stock representing the entire ownership of the property of the corporation necessarily includes the surplus and undivided profits. If the fair average value is determined from the book value they are included in the assets; if from sales, they are necessarily taken into consideration in establishing the market price; and if from net income, they are more or less reflected through the earnings.[19] Corporations are now required to make three exhibits: Exhibit A being a condensed balance sheet; Exhibit B, quotations or outside sales prices; and Exhibit C, the annual income for a period of five years. The fair average value of capital stock is not necessarily the book value, or the market value or even the earning value, although it is often more directly dependent upon the last. The taxpayer is required to report as the fair value of its capital stock the amount reflected by the exhibit showing the greatest value. However, corporations materially affected by extraordinary conditions are permitted to report the amount reflected by the exhibit which in their opinion more clearly shows the required value, in which case it is necessary to attach to the return a comprehensive statement explaining why the tax should be so assessed. The Commissioner will estimate the fair value of the capital stock in cases regarded as involving any understatement or undevaluation.[20]

Exhibit A: Condensed Balance Sheet. This exhibit furnishes a condensed balance sheet as of the closing date of a fiscal

18 Reg. 50, Art. 23.

19 Reg. 50, Art. 24.

20 Reg. 50, Art. 102. See Form 707. Prior to July 1, 1918, it was the practice of the Treasury Department to determine the fair average value of capital stock by means of either (a) the average price at which stock had sold during the preceding year or (b) by estimating the value of the capital stock, taking into consideration the surplus and undivided profits for the preceding fiscal year as well as the nature of the business, its earning capacity and average dividends paid from profits earned during the preceding five years. Only in exceptional cases where the corporation had no net income or only occasional income was the value of the capital stock predicated upon the value of the assets of the corporation. Reg. 50, Art. 102.

year ending on June 30, or on some date between July 1 and June 30, of the preceding year. In one column the value shown on the books of account is required to be stated and in a parallel column adjustment may be made for any overstated or understated values shown on the books of account. In a third column the taxpayer is required to show the difference between the book values and the "fair value." Any material difference is to be explained in such manner as to enable the Commissioner to determine if the "fair value" is proper and acceptable. In making adjustments from book values to fair value it is not necessary for the taxpayer to make corresponding adjustments on its books of account. In the event that the taxpayer holds in its treasury any of its own stock or bonds it is required that advice be given as to whether such stock or bonds are pledged or unpledged.

EXHIBIT B: QUOTATIONS OR OUTSIDE SALES PRICES. In this exhibit the taxpayer is required to show prices quoted on a recognized stock exchange or on the New York Curb, or the prices at which outside sales were made if the stock was not listed, for the period of twelve months ending with the close of the taxpayer's last fiscal year. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations must accompany the return. Sales to employees or directors for qualifying shares, or sales which were restricted as to resale, or sales at prices otherwise specially influenced, are not considered representative of the fair value of the entire capital stock and should not be reported.

EXHIBIT C: ANNUAL INCOME. In this exhibit the taxpayer is required to furnish data for the five fiscal years ended with the close of the taxpayer's last fiscal year or for the period during which the corporation had been engaged in business, if for a shorter period. The net income reported for the purpose of the income tax is required to be stated in this exhibit. Such net income, however, may be adjusted by deductions or additions in order to reach the actual operating income. Among the principal items which may require adjustment are stated: income taxes not deductible in computing income subject to tax; losses not fully deductible; dividends from other corporations not included in computing income subject to tax; income exempt for purpose of the income tax; expenditures made for additions or betterments, or reserves for such purposes, made against income whether direct or through

expenses. The adjusted income will be averaged for the years reported and such average income capitalized at such percentage as the officers of the company making the return from their special familiarity with the business know representative enterprises in their line in their locality must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business find it necessary on the average to earn 8% on their issued capital stock to keep the value of their stock at par, the net income of the corporation making the report is to be capitalized by dividing it by .08. If possible, illustrations drawn from similar corporations should be cited in support of the percentage adopted. The purpose of this schedule is to permit the taxpayer to take into consideration any and all abnormal conditions affecting the book value of the assets or the earning power of the corporation as shown by its average net income. Such opportunity having been given, the book value of the assets and the capitalized net income are compared with the actual sales prices of the stock and the largest of the three is taken as representing the fair average value of the capital stock unless the Commissioner can be convinced that one of the other two values more clearly reflects the fair average value of the capital stock.[21]

Foreign Corporations. The tax is at the rate of $1 for each full $1,000 of the capital of a foreign corporation actually employed in the transaction of its business in the United States, and is in all cases to be computed on the basis of the average amount of capital so employed during the preceding year ending June 30. The basis of the tax is accordingly different from that in the case of domestic corporations, which pay a tax measured by the fair average value of their capital stock. No deduction from the total fair average value is allowed in computing the tax.[22] The "capital employed in the transaction of its business in the United States" means that portion of the total capital, surplus and undivided profits of the foreign corporation

[21] Reg. 50, Art. 102. See Form 707. It has been held that income and excess-profits taxes may be properly deducted from net income, as reported under Exhibit C, even though not actually paid, if the amount has been definitely determined and explanations are submitted for consideration in the final audit. (Telegram from Treasury Department dated July 10, 1919: W. T. S., ¶ 3126.)

[22] Reg. 50, Art. 32.

utilized for the purpose of doing business in the United States. The tax is imposed upon capital employed irrespective of its nature, whether borrowed, paid in, or earned. Any surplus or undivided profits invested in United States bonds or other securities having no connection whatever with the actual business of the corporation transacted in this country is not "capital employed in the transaction of its business in the United States."[23] A foreign corporation may have income from sources within the United States for the purpose of the income tax and yet not have capital employed in the transaction of business here for the purpose of the capital stock tax. A foreign corporation actually itself not doing business in the United States is not subject to the tax, and accordingly the investment of a part of its funds in United States stocks and securities would not constitute capital employed in its business in the United States. But if a corporation does business here, then, although the mere investment of funds in United States securities is not such a taxable employment of capital, such investment will constitute capital employed in the transaction of business in the United States if made in a subsidiary corporation which the foreign corporation uses as an instrumentality for the successful conduct of its own business here. Thus funds of a foreign corporation invested in the purchase of facilities, though apparently independent, for the purpose of its business here, or the purchase of stock and securities of a subsidiary corporation for the same purpose, will constitute capital employed in the transaction of business in the United States. A foreign corporation may not escape taxation by organizing or purchasing stock of another corporation to own the facilities which the taxpayer needs in its business. A foreign corporation may employ capital in the transaction of its business in the United States in various ways, as, for example, in the investment of funds in property in the United States used in its business, in stocks and securities of subsidiary corporations as explained above, in bills and accounts receivable representing business done in the United States, in merchandise kept here for sale, in materials manufactured here, and in deposits

[23] Letter from Treasury Department dated February 10, 1919; W. T. S. 1918, ¶ 3131; Telegram from Treasury Department dated October 30, 1919; W. T. S., 1919, ¶ 3128.

in United States banks maintained for use in business here, and not merely for convenience or investment.[24] In general, approximately such proportion of the entire capital of a foreign corporation will probably be employed in the transaction of its business in the United States as the gross amount of its business in the United States bears to its total gross business, but this is not always true, for a corporation may conceivably transact a greater or less volume of business in one country than in another on the same amount of capital. The basis of the tax is the average amount of capital employed in the transaction of business in the United States during the preceding fiscal year. It will usually be sufficient to determine the amount of capital so employed at the beginning of such year and the amounts so employed at the end of such year and to divide the sum of such amounts by two. However, where there have been material changes in the amount of capital the average amount should be determined with due regard to the times at which such changes occurred. The foreign corporation may, if desired, compute the average amount of capital employed on a monthly basis.[25]

Stock Insurance Companies. Insurance companies having capital stock, as distinguished from mutual insurance companies, are taxable like other corporations, whether domestic or foreign. In ascertaining the fair value of their capital stock for the purpose of the tax, however, such deposits and reserve funds of insurance

[24] Reg. 50, Arts. 33 and 34. See T. D. 2467.

[25] Reg. 50, Arts. 34 and 35. One of the rules prescribed by the Treasury Department for determining capital employed in the transaction of business of a foreign corporation in the United States for the year ending June 30, 1917, was as follows: (1) Take the entire invested capital of the corporation, as shown by its last return within the year ending June 30 for the purpose of the war excess-profits tax imposed by the Act of October 3, 1917, or if no such excess-profits tax return has been made by the corporation, compute the invested capital for its fiscal year ending within the year ending June 30 in accordance with the War Excess Profits Tax Regulations. (2) Find the proportion, expressed in percentage, which the net income from sources within the United States bears to the entire net income for the fiscal year ending within the year ending June 30, such income being ascertained upon the same basis and in the same manner as for the income and excess-profits taxes. (3) Apply the percentage found in (2) to the average invested capital ascertained in (1), the result being the amount of capital invested in the United States. (Reg. 38 Rev., Art. 20.)

companies as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders, and reserves which represent actually accrued liabilities, the credits to which are deducted from gross income as ordinary and necessary business expenses, are to be omitted from the calculation. But if the fair average value is estimated from the market price of the shares of stock of the company, no deduction for deposits or reserves is proper from the total value so established.[26]

Mutual Insurance Companies. The tax applies to domestic and foreign mutual insurance companies. A mutual protective association organized under a statute, whose only source of revenue is the assessments paid by its members and whose net income for each year is paid into a reserve fund, constituting the sole resource of the company, aside from current assessments for the payment of losses, is an insurance company within the meaning of the statute. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer.[27]

Domestic Mutual Insurance Companies. The tax is $1 for each full $1,000 of the excess over $5,000 of the sum of (a) the surplus or contingent reserves maintained for the general use of the business and (b) any reserves the net additions to which are included in net income for the purpose of the income tax, in both cases figured as of the close of the last taxable year of the company. The net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds and, in the case of corporations issuing policies covering life, health and accident insurance combined in one policy issued on the weekly premium payment plan continuing for

26 Reg. 50, Art. 41.

27 Reg. 50, Art. 61. Revenue Act of 1918, § 1000 (c). Under the 1916 capital stock tax law it was held that mutual insurance companies and other associations not having capital stock represented by shares would be held exempt from the tax in the absence of a basis for the computation thereof under that law. T. D. 2364.

life and not subject to cancellation, including such portion of the net addition not required by law made within the taxable year to reserve funds as is needed for the protection of the holders of such combination policies, is not included in net income for the purpose of the income tax.[28]

FOREIGN MUTUAL INSURANCE COMPANIES. The tax is $1 for each full $1,000 of the same proportion of the sum of (a) and (b) in the last paragraph which the reserve fund upon business transacted within the United States is of the total reserve upon all business transacted, calculated as of the close of the last taxable year of the company.[29]

Holding Companies. The Treasury Department held under the 1916 Law that a domestic holding company whose objects and activities were exclusively restricted to holding the stock and securities of other corporations was not "doing business" and was, therefore, not subject to tax.[30] This ruling was based upon a case[31] holding that no holding company can exist without a corporate activity involved in the exercise of control of its subsidiaries through stock ownership, but such corporate activity is not the exercise of a franchise which is subject to an excise tax. If a holding company is "doing business" no deduction is allowed to it for the tax paid by its subsidiary.[32] Foreign holding companies are held by the Treasury Department to be subject to the same rule.

Subsidiary Companies. A subsidiary company is taxed regardless of its relations to the principal or parent company.[33] The law does not provide against taxation of the value of the capital stock of parent and subsidiary corporations, although the value of both may be supported in part by the same assets.

Corporation Engaged in Business During Preceding Year. The tax being payable in advance does not apply to any corporation

28 Reg. 50, Art. 62.

29 Reg. 50, Art. 62.

30 Reg. 50, Art. 19. Reg. 38 Rev., Art. 6. These regulations reversed the earlier holding of the Treasury Department, and were based upon the case cited in the next note. See T. D. 2429. T. D. 2503.

31 Butterick Co. v. U. S., 240 Fed. 539; U. S. v. Nipissing Mines Co., 206 Fed. 431. See the paragraph on Carrying on or Doing or Engaging in Business, post.

32 Reg. 50, Art. 106; Reg. 38 Rev., Art. 24.

33 Revenue Act of 1918, § 1000 (a) (1). Reg. 50, Art. 106. See T. D. 2493, as amended by T. D. 2509.

which was not engaged in business during any part of the fiscal year preceding the year for which the tax is due, but if it was in business even one day of the preceding year and one day of the taxable year, it is subject to the tax.[34] There is no relation between the amount of the tax payable and the length of time the corporation was in business. A corporation engaged in business during a part of the preceding year, but not engaged in business at the beginning of the taxable year, is not required to make any return if it is dissolved or in process of dissolution, but if it is only temporarily inactive and subsequently during the year engages in business it should file a return in the month in which it recommences business. A corporation organized after the beginning of a taxable year is not subject to the tax for the remaining portion of the year in which it was organized, but when one corporation succeeds another on July 1 of any year and pursuant to an agreement entered into between the respective organizations during the preceding fiscal year ceases to do business at that time, the business being carried on thereafter by the new concern, the new corporation is liable to the tax. "Engaged in business" in the case of a foreign corporation means engaged in business in the United States.[35]

Inactive Corporations. A domestic corporation is not taxable unless it carries on or does business in the taxable year. But if such corporation has paid the special excise tax at the beginning of the taxable year and ceases to do business before the close of that year, no refund is allowed for that portion of the year in which the corporation does no business.[36] The same rule applies in respect of foreign corporations except that the business in question must be engaged in or carried on or done in the United States.

Carrying on or Doing Business During Taxable Year. A domestic corporation not engaged in business at the beginning of the taxable year is not required to file a return or pay a tax, although it may have been engaged in business during a part of the preceding year. If such corporation resumes business at any time during the taxable year, it will be required, at that time, to make a return and pay the tax for the proportion of the year in

[34] Reg. 50, Art. 51; Reg. 38 Rev., Art. 11; T. D. 2417.

[35] Reg. 50, Art. 51.

[36] See R. S., § 3237.

which it intends to do business. In such cases the tax is computed proportionately from the first day of the month in which it carries on or does business to the end of the taxable year. Thus, if a corporation was engaged in business during some part of the preceding year, but was not engaged in business on the first day of the taxable year, but subsequently engages in business in the third month of the taxable year, the return is required to be filed and the tax be paid at that time, for ten-twelfths of the full taxable year. If an inactive corporation was not engaged in business during any part of the preceding year, it is not taxed in the year it resumes activity, but makes a return and pays the tax at the beginning of the next taxable year.[37] A corporation organized after the beginning of the taxable year is not subject to tax for the remaining portion of the year in which it was organized, but when one corporation succeeds another at the beginning of a taxable year, and the old corporation, pursuant to an agreement entered into between the respective organizations during the preceding year, ceases to "do business" at that time, the business being carried on thereafter by the new concern, the new corporation is liable to tax.[38]

Carrying on or Doing Business. The tax is imposed "with respect to the carrying on or doing business" by a corporation. It may be described generally as a tax upon the doing of business in the capacity of a corporation, joint-stock company, or insurance company. "Business" is a very comprehensive term and embraces everything about which a person can be employed. Every corporation that is doing business, and no corporation that is not carrying on or doing business, is subject to the tax. As corporations are organized to do business, every existing corporation will be presumed to be subject to the tax unless it submits proof satisfactory to the Commissioner that it is not doing business. The distinction is between the mere ownership of property and the actual doing of business in the capacity above designated. The fair test is whether a corporation has reduced its activities to the owning and holding of property and the distribution of its avails and doing only the acts necessary to continue that status, or is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such

37 Reg. 38 Rev., Arts. 1 and 11.
38 Reg. 38 Rev., Art. 11.

activities as are essential to those purposes.[39] The meaning of the term "engaged in business" in relation to domestic corporations was defined by a number of decisions under the 1909 Law, with particular reference to cases where corporations had ceased to do business. Thus, it was held that where a corporation, originally organized for the purpose of owning and renting an office building, leased its property for 130 years, its sole authority under its charter thereafter being to hold the title subject to the lease and to receive and distribute the rentals which might accrue under the terms of the lease, or the proceeds of any sale of the land should it be sold, it was not engaged in business within the meaning of that law.[40] The actual terms of the lease will assist in deciding a question of this kind. In another case, it was held that a railroad corporation which had leased its property for a term of years, and parted with its control and management, maintaining, however, its corporate organization, collecting rentals from the lessee, and distributing the same among its stockholders, was not engaged in business. The mere receipt of interest and dividends from invested funds, bank balances, and the like, and the distribution among the stockholders of a corporation, amount to no more than receiving the ordinary fruits that arise from the ownership of property and do not constitute doing business. The mere ownership of undeveloped coal or timber lands, without operating them, does not constitute doing business.[41] Where, however, a corporation was organized to build and lease property, the fact that it had leased all of its property and did nothing except collect and distribute the rents, did not exempt it from the tax, since such collection and distribution of rents from the leased property was the business for which it was organized.[42] A company whose activities include something more than the mere holding of property and the distribution of the receipts thereof is

39 Reg. 50, Art. 17. Reg. 38 Rev., Art. 4. Von Baumbach v. Sargent Land Co., 242 U. S. 503.

40 Zonne v. Minneapolis Syndicate, 220 U. S. 187. In a later case it was held that, although a corporation might have power to do business under its charter, if it had leased all its property and was merely collecting rent it was not engaged in business. U. S. v. Emery, etc., Co., 237 U. S. 28; Reg. 50, Art. 19.

41 McCoach v. Mine Hill & Schuylkill Haven R. R. Co., 228 U. S. 295; West End Street Ry. Co. v. Malley, 246 Fed. 625. Reg. 50, Art. 19.

42 Rio Grande Junction Ry. Co. v. U. S., 51 Ct. Cls. 274.

"doing and engaging in business."[43] These and other decisions[44] will be followed by the Treasury Department where the decisions are by the United States Supreme Court or, if by the lower courts, have been acquiesced in by the Department. Corporations organized for the purpose of buying, owning, exploring, developing, leasing, improving, selling and dealing in lands, mining properties, tenements, and hereditaments, are considered to be engaged in business if they perform any of their powers. It is not necessary that such a corporation be an operating company in order to be taxable under this law. If a corporation is doing any one of the several things it is authorized to do, by its charter, it is carrying on or doing business and subject to this tax.[45] But if a corporation is solely a holding company it is not carrying on or doing business within the meaning of the law.[46] Corporations, all of whose property and business is operated by or in the hands of receivers appointed by a court or the Alien Property Custodian, are not engaged in business.[47] Corporations organized for the purpose of doing business and actually engaged in such activities as buying timber lands and other real estate, leasing property, collecting rents, managing office buildings, making investments of profits, or leasing ore lands and collecting royalties, managing wharves, dividing profits and in some cases investing the surplus, are engaged

43 Von Baumbach v. Sargent Land Co., 242 U. S. 503. The activities referred to in this case included selling and leasing property, selling stumpage, making explorations, and employing another company to see that mining operations were properly carried on and that the lessees lived up to their engagements.

44 Other cases arising under the 1909 Law are: Anderson v. Morris & Essex R. R. Co., 216 Fed. 83; Cambria Steel Co. v. McCoach, 225 Fed. 278; Jasper, etc., Ry. Co. v. Walker, 238 Fed. 533; Lewellyn v. Pittsburg, etc., R. R. Co., 222 Fed. 177; McCoach v. Continental Passenger Ry. Co., 223 Fed. 976; Miller v. Snake River Valley R. R. Co., 223 Fed. 946; New York Central v. Gill, 219 Fed. 184; New York Mail, etc., Co. v. Anderson, 234 Fed. 590; Philadelphia, etc., R. R. Co. v. Lederer, 242 Fed. 492; Philadelphia Traction Co. v. McCoach, 224 Fed. 800; Public Service Electric Co. v. Herold, 229 Fed. 902; Traction Companies v. Collector of Internal Rev.; 223 Fed. 984; Wilkes-Barre, etc., Traction Co. v. Davis, 214 Fed. 511; Boston Terminal Co. v. Gill, 246 Fed. 664; Old Colony R. Co. v. Gill, 257 Fed. 220.

45 T. D. 2457; Reg. 50, Art. 18.

46 Butterick Co. v. U. S., 240 Fed. 539; Reg. 38 Rev., Art. 6; Reg. 50, Art. 19.

47 Reg, 50, Art. 19. Reg. 38 Rev., Art. 6; T. D. 2424.

in business within the meaning of the statute. A corporation engaged in mining, or in developing and speculating in mineral lands, is doing business. A parent corporation which finances or manages the operations of its subsidiaries is doing business. A corporation engaged in buying and selling securities or other property is doing business, even though for a period it makes no purchases or sales because of unfavorable market conditions. A corporation formed to take over miscellaneous stocks, bonds, and other property (as from an estate), to negotiate the sale of the various items from time to time as opportunity and judgment dictate, and to distribute the proceeds from time to time as liquidation is effected, is while engaged in such liquidation carrying on business.[48]

"Doing Business" by Railroad Corporation Under Federal Control. A corporation owning a railroad controlled and operated by the Government is exempt from liability for a given tax year only in case it does no business during such year. The liability of a corporation which actually does business is not affected by the control over its railroad exercised by the Government. For the purpose of determining whether or not a corporation owning a railroad operated and controlled by the Government did or did not do business during a given year, the following rules have been laid down: (a) a corporation may perform the acts necessary to maintain an effective organization, offices and clerical force, pay salaries, elect directors and officers, hold meetings, etc., without being regarded as doing business; (b) the tax does not attach because of mere naked ownership of either railroad property or other property; (c) a corporation which takes any part in the actual management of a railroad or other enterprise, as, for instance, a coal mine, is doing business, but a corporation may collect and distribute the income from property which it does not manage without incurring liability; (d) a corporation which directly maintains or improves, or enters into wire, siding, conduit, crossing, or other contracts for the maintenance or improvement of railroad or other directly productive property, will generally be held liable, but if the execution of such contracts by the corporation is a mere formality for the accommodation of the United States Railroad Administration, and the financial responsibility therefor is assumed by the United States,

[48] Reg. 50, Art. 18.

the execution thereof will not be regarded as doing business by the company; (e) borrowing for the purchase of Government bonds or in connection with obligations previously assumed is not regarded as doing business, but borrowing for the purpose of financing new operations will be regarded as the doing of business unless it is for the accommodation of the United States Railroad Administration, as outlined in (d) above; (f) a corporation may purchase stocks of other concerns and similar intangible property, which would be considered as "maintaining investments," without incurring liability, but the purchase of railroad equipment or of real estate or other tangible property, whether for railroad or other productive purposes or for resale, is doing business; (g) a concern which sells its entire property, or a part once used in operating its business, for which it has no further use in the conduct of its business, does not thereby incur liability, but this would presumably not apply to the sale of property not acquired for use in connection with the conduct of the business, and the sale of property acquired for speculative purposes or in the course of a business of dealing in such property would cause liability to attach; (h) a concern which makes long term leases, whereby it parts with the control of the property, which is to be maintained by the lessee, will be regarded as thereby going out of business with respect to such property, and the execution of such leases will accordingly not be treated as doing business, but the execution of leases whereby the corporation is obligated to maintain the property or covering property held for renting purposes will be regarded as doing business. Pursuant to the foregoing rules it is concluded that: (1) A corporation owning a railroad operated by the Government may without incurring liability to the tax (a) maintain its corporate organization; (b) own property; (c) collect and distribute the income therefrom; (d) purchase stocks and bonds of other organizations; (e) sell all or part of the property used in the operation of its railroad or other business; (f) enter into long term leases whereby it is divested of control of and is not obligated to maintain the property; and (g) borrow money for the purchase of Government bonds or for the financing of obligations incurred prior to Government control. (2) A corporation will incur liability if it (a) manages, (b) maintains or (c) purchases railroad or other tangible property; (d) sells property

not used in the conduct of the railroad or other business; (e) borrows money for the financing of new operations; or (f) makes leases of property held for renting purposes, or whereby it is obligated to maintain the property. The extent of the activity, if it is of a kind causing liability to the tax, is unimportant. To assist in determining the question of liability under the statute as interpreted in the rules laid down above, each corporation owning a railroad under federal control and operation and claiming exemption from the tax will be required to file an affidavit supplying the information necessary for a decision. No claim on file or hereafter filed will be favorably considered in the absence of such an affidavit. A printed form of affidavit has been prepared, of which copies may be secured upon application to the Commissioner. These principles apply equally to steamboat lines.[49]

Doing Business by Foreign Corporations. A foreign corporation is "carrying on or doing business" in the United States if it maintains agents or an office or warehouse here, or in the case of an insurance company writes insurance policies here or in any other way enters the United States for the purpose of its business.[50] The meaning of the term in relation to foreign corporations has been referred to in a previous paragraph.[51]

Exempt Corporations. The special excise tax is expressly made inapplicable to any corporation exempt for income tax purposes.[52] As foreign corporations falling within the classes enumerated as exempt in the income tax law (except in the case of building and loan associations and cooperative banks) are exempt for income tax purposes,[53] they are also exempt from this tax, if falling within such enumerated classes. A corporation paying this tax is not on that account exempt from any occupational tax.[54]

Tax Due. This tax is an excise tax on the privilege of doing business, similar to occupational taxes imposed on individuals. Being a privilege or occupational tax, it is payable annually, in ad-

49 Reg. 50, Arts. 20 and 21.

50 Reg. 50, Art. 31; Reg. 38 Rev., Art. 13.

51 See pp. 717, 720.

52 Revenue Act of 1918, § 1000 (c); Reg. 50, Art. 52.

53 Letter from Treasury Department dated December 6, 1916; I. T. S. 1918, ¶ 1182; Reg. 38 Rev., Art. 12.

54 Reg. 50, Art. 91; Reg. 38 Rev., Art. 17.

vance for each year beginning July 1. Special taxes, of which this is one, become due on the first day of July in each year, or on commencing any trade or business on which such tax is imposed.[55] The tax is payable to the collector at any time after such due date, but penalties for non-payment do not attach until ten days after notice and demand therefor have been served by the collector upon the taxpayer.[56]

Returns. Returns are required to be filed on or before the 31st of July of each year with the collector of the district in which the principal place of business of the corporation is located. Forms will be sent to taxable corporations known to collectors, but failure to receive a blank form will not relieve a corporation from the penalties prescribed by law for failure to make the return within the time required.[57] All the information called for in the forms must be given in every case where it is procurable.[58]

In What Cases Required. A return is required of every domestic corporation engaged in business, having a capital stock issued and outstanding, regardless of the par value, or the actual value, of its capital stock, unless such corporation was not engaged in business during the preceding taxable year.[59]

Extension of Time. If failure to file a return is due to sickness or absence, the collector may allow such further time, not exceeding 30 days, for making and filing the return as he deems proper.[60] There is no authority in the law for granting an extension *for any reason* beyond 30 days from July 31 and a corporation with a fiscal year ending on June 30 will be obliged to file its capital stock return on or before August 30 even though it has not yet filed its income tax return. Such corporations should complete their capital stock returns insofar as practicable and file with them a statement

55 Reg. 50, Art. 1.

56 See T. D. 2423, and Chapter 35 for rulings as to notice and demand.

57 Reg. 50, Art. 104. Reg. 38 Rev., Art. 21. T. D. 2364. Domestic corporations use Form No. 707 and foreign corporations Form No. 708.

58 Reg. 50, Art. 101.

59 Reg. 50, Art. 23; Reg. 38 Rev., Art. 18. If a corporation claims exemption on the ground that it is not doing business, it should complete the first five lines of Form 707, attaching comprehensive explanation of such grounds. (Telegram from Treasury Department dated July 25, 1919; W. T. S. 1919, ¶ 3127).

60 Reg. 50, Art. 104.

that unavailable data will be furnished in a supplemental report as soon as possible. This procedure will obviate any assertion of penalties and any question as to what constitutes a reasonable cause.[61]

Returns to Be Public Records. Returns filed pursuant to the special excise tax law, constitute public records, and are open to inspection in all respects the same as income tax returns.[62]

Returns by Affiliated Corporation. So-called subsidiary corporations, all or a part of the stock of which is owned by another corporation, must render returns in the same way as other corporations. No deduction is allowed in the return of a holding corporation for the tax paid by a subsidiary. Although the Revenue Act of 1918 requires a consolidated return for affiliated corporations for the purpose of the income and war-profits and excess-profits taxes, for the purpose of the capital stock tax each corporation must render a separate return. If the fair value of its capital stock is based upon a consolidated report, a copy of such report should be attached to the capital stock tax return of each affiliated corporation including the parent company. In order that the Commissioner may have the benefit of all information possible in the audit, the following suggestions are made: (a) that the parent company submit with its return a list of all subsidiaries and the districts in which the returns were filed; (b) that the return of the subsidiary company should show the name of the parent company and the district in which the return was filed, (c) that the method of determining the fair value, if other than by exhibits A, B and C, should be fully explained; (d) that a copy of any agreement existing between parent company and subsidiary should be furnished, or a statement made that none exists; and (e) that a combined balance sheet and a combined net income statement be submitted for consideration in connection with any estimate of fair value made on behalf of the reporting corporation.[63]

Returns of Affiliated Corporations Based upon Consolidated Report. In many cases, as for instance, in the case of selling

61 Letter from Treasury Department dated July 11, 1919; W. T. S. 1919, ¶ 3126.

62 Revenue Act of 1918, § 1000 (d); Reg. 50, Art. 71.

63 Reg. 50, Art. 106; letter from Treasury Department dated June 2, 1919; W. T. S. 1919, ¶ 3120.

agencies separate corporations are formed in order properly to handle certain business under various state laws and in reality are branches or departments of the parent corporation. The business is controlled by the parent corporation and the result of operations is a matter of bookkeeping. The capital stock tax being imposed upon the fair value of the capital stock of corporations, it makes little difference by what method such fair value is determined. Therefore, if the fair value of the capital stock of affiliated corporations cannot be determined independently and such corporations are best able to determine the fair value of the respective companies through a consolidated report, such privilege is permitted by the Department, but it seems preferable to leave this to the corporations interested subject to approval by the Commissioner rather than attempt to outline a specific method that would apply to all. Under all circumstances, however, separate *returns* are required of all affiliated corporations, regardless of the basis used in arriving at fair value.[64]

Returns by Foreign Corporations. A return is required of every foreign corporation engaged in business in the United States, irrespective of the amount of capital employed either in this country or elsewhere in the transaction of its business.[65] Returns are filed with the local collector under the rules which apply to the filing of returns of annual net income.[66] The capital actually employed in the transaction of the business of the foreign corporation in the United States and the tax payable thereon should be calculated in accordance with the instructions on the Form (Form 708).[67]

Payment of the Tax. All assessments are made by the Commissioner. The collector, within ten days after receiving any list of taxes from the Commissioner gives notice to each corporation liable to pay any tax stated therein, to be left at its place of business or to be sent by mail, stating the amount of such tax and demanding payment thereof. A collector has no authority to extend the time for payment of the tax. The collector may accept pay-

64 Letter from Treasury Department dated June 2, 1919; W. T. S. 1919, ¶ 3120; letter from Treasury Department dated November 11, 1919; W. T. S. 1919, ¶ 3129.

65 Reg. 50, Art. 103.

66 See Reg. 38 Rev., Appendix B.

67 Reg. 50, Art. 103.

ment of the tax when the return is filed as an "advance collection," subject to any adjustment later found necessary, but no corporation is required to pay the tax until within ten days after notice and demand.[68]

Penalties. Any corporation carrying on business within the meaning of Section 1000 of the Revenue Act of 1918 without having paid the tax therein provided is subject to a penalty of not more than $1,000 besides being liable for the payment of such tax.[69]

PENALTIES FOR FAILURE OR REFUSAL TO MAKE RETURN. Any corporation which fails to make a return at the required time is liable to a penalty of $1,000. If it wilfully refuses to make a return it is also liable to a fine of $10,000 and costs. Any officer or employee of a corporation who in the course of his duty fails to make a return at the required time is liable to a penalty of $1,000. If he wilfully refuses to make a return he is also liable to a fine of $10,000 and costs and to imprisonment for a year.[70] If a corporation fails to make a return on or before the time required by law in any year, the collector or deputy collector may make a return from his own knowledge or from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge or from such information as he can obtain through testimony or otherwise, make a return or amend any such return made by a collector or deputy collector. Any return so made and subscribed by the Commissioner, or by a collector or deputy collector, and approved by the Commissioner is *prima facie* good and sufficient for all legal purposes. A penalty of 25% of the amount of the tax so found due will be added, unless a return is made and it is shown that the failure to file it was due to a reasonable cause, and not to wilful neglect. The amount so added to any tax (or the amount added, as stated in the next paragraph) will be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added will be collected in the same manner as the tax.[71]

68 Reg. 50, Art. 111. For the provisions relating to payment by uncertified checks and the procedure with respect to dishonored checks see Chapter 35 and Reg. 50, Arts. 141 and 142.

69 Revenue Act of 1918, § 1005; Reg. 50, Art. 91.

70 Reg. 50, Art. 122.

71 R. S. § 3176, as amended by the Revenue Act of 1918; Reg. 50, Art. 122.

FALSE OR FRAUDULENT RETURN. In case a false or fraudulent return is wilfully made, the Commissioner will add to the tax 50% of the amount thereof.[72]

PENALTY FOR DELAY IN PAYING TAX. Upon failure to pay the tax assessed within ten days after notice and demand, a penalty of 5 per cent of the tax unpaid, and interest at the rate of one per cent per month until paid, is added to the amount of such tax.[73] Any corporation which fails to pay the tax when due and payable is liable to a penalty of $1,000. If it wilfully refuses to pay or wilfully attempts to evade the tax, it is also liable to a fine of $10,000 and costs and to a 100 per cent penalty to be added to the tax. Any officer or employee of a corporation who in the course of his duty fails to pay the tax when due and payable is liable to a penalty of $1,000. If he wilfully refuses to pay or wilfully attempts to evade the tax, he is also liable to a fine of $10,000 and costs and to imprisonment for a year, and to a penalty of the amount of the tax unpaid or evaded.[74]

Foreign Corporations Subject to Penalties. The above penalties apply to foreign corporations as well as domestic corporations.[75]

Administration of the Law. All administrative or special provisions of the internal revenue laws including the laws relating to the assessment of taxes, so far as applicable, are extended to and made a part of the Revenue Act of 1918 (including the Special Excise Tax) and every corporation liable to the tax considered in this chapter is required to keep such records and render, under oath, such statements and returns, and comply with such regulations as the Commissioner may prescribe.[76]

[72] R. S. § 3176, as amended by the Revenue Act of 1918; Reg. 50, Art. 122.
[73] Revenue Act of 1918, § 1305; R. S. § 3184.
[74] Reg. 50, Art. 121.
[75] See Reg. 38 Rev., Appendix B.
[76] Revenue Act of 1918, § 1305.

CHAPTER 45

THE STAMP TAX

The present stamp tax is imposed under Title XI of the Revenue Act of 1918, which became a law on February 25, 1919. This title is to some extent a re-enactment of the War Stamp Tax Act of 1917 (Title VIII of the Act of October 3, 1917, referred to in this chapter as the "former" or 1917 law), but the two acts differ in certain respects. The Revenue Act of 1918, like the former law, does not contain Schedule B of the Act of October 22, 1914 (referred to in this chapter as the 1914 Law), which provided for a tax on perfumery, cosmetics and similar articles, and chewing gum or substitutes therefor. The 1914 Law was preceded by the Act of June 13, 1898 (referred to in this chapter as the 1898 Law).[1] The taxes imposed by the Revenue Act of 1918 are, in the case of any article upon which a corresponding stamp tax was hitherto imposed by law, in lieu of such tax.[2] The date of the incidence of the tax, that is, the first day on which the tax applied, was April 1, 1919.[3]

General Scope of Present Law. The present law taxes the following subjects: Bonds (of indebtedness, indemnity and surety), the original issue of certificates of stock or of profits or interest in property or accumulation of corporations, the sale or transfer of shares or certificates of stock or of profits or of interest in property or accumulation in corporations, sales of produce on exchange, drafts or checks (payable otherwise than at sight or on demand), promissory notes, conveyances, entries of goods at custom house, entry for withdrawal of goods from custom bonded warehouse, passage tickets on vessels to foreign countries (except Canada or Mexico), proxies, powers of attorney, playing cards, parcel post

1 Other stamp tax acts will likewise be referred to in this chapter for the sake of brevity by the year of their respective enactments.

2 Revenue Act of 1918, § 1100.

3 The former law went into effect on December 1, 1917, except as to the tax on playing cards, which became effective on October 4, 1917.

packages and certain insurance policies.[4] The several subjects appear below in alphabetical order, together with the rates applicable to each and rulings with respect to each. This list includes a number of instruments not taxable under the present law to which reference is made for the convenience of the reader who may be searching for positive assurance that a particular instrument need not be stamped.

General Exemptions. The following are not subject to stamp tax: (a) bonds, notes, or other instruments issued by the United States, or by any foreign government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; (b) bonds of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States; (c) stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigating companies.[5] Special exemptions applying to various instruments specified in the law are referred to in the paragraphs dealing with such instruments.

Stamps. Stamps are kept on sale by the various collectors of internal revenue and postmasters in the United States,[6] and are also on sale at United States depositaries.[7] Stamps issued under the 1914 and 1917 Laws may be used in paying stamp taxes pursuant to the Revenue Act of 1918.[8]

WHERE STAMPS ARE AFFIXED. As a rule, stamps are affixed to the taxable document or instrument, but in some instances a different rule prevails, as will appear in the following paragraphs. Stamps to be affixed to articles manufactured in a foreign country and imported into the United States may be purchased and for-

[4] Revenue Act of 1918, Title XI Schedule A.

[5] Revenue Act of 1918, § 1101. Under (b) above, indemnity bonds given by soldiers, sailors, marines or other persons entitled to insurance under the War Risk Insurance Act, for the protection of the United States against loss by reason of the issuance of duplicate checks for such insurance, are exempt from the stamp tax. (T. D. 2900.)

[6] Revenue Act of 1918, § 1106; Reg. 55, Arts. 163-4.

[7] Revenue Act of 1918, § 1107.

[8] Reg. 55, Art. 169.

warded to the place of manufacture and there affixed to the articles before the same are packed for importation.[9]

WHO AFFIXES STAMPS. It is contemplated that stamps shall be affixed by the person issuing the document or instrument. Thus, the maker of a promissory note is primarily obliged to affix the proper stamp thereto, and likewise, the obligor should affix the proper stamp to a bond. However, it is secondarily the duty of a person accepting or receiving any such document or instrument to affix a stamp thereto and he is subject to penalty if he does not do so.[10] It has been held that it makes no difference who affixes the stamp, as long as a stamp of the proper denomination is affixed to the instrument. Both parties to a taxable instrument are responsible to the Government for affixing and canceling stamps in the required amount. The law does not prohibit parties in interest from entering into an agreement as to which of them shall actually pay same.[11]

CANCELLATION OF STAMPS. Stamps are cancelled by the person using or affixing the stamp, by writing or stamping thereon or causing to be written or stamped thereon in ink his initials and the day, month, and year on which the stamp is used or affixed. or by cutting and cancelling the stamp with a machine or punch, which will affix the initials and date as aforesaid and so deface the stamp as to render it unfit for reuse. In addition, stamps of the value of 10 cents or more are required to be cancelled by three parallel incisions made by some sharp instrument lengthwise through the stamp after the stamp has been attached to the instrument, except that this is not required where stamps are cancelled by perforation. The cancellation by either method should not so deface the stamp as to prevent its denomination and genuineness from being readily determined.[12] The perforating machine may also imprint the initials and date or outline the same in small perforations, thus effecting complete cancellation, or the initials and date may be written on the stamp, and several perforations, sufficient to prevent washing and resale of the stamp may be made with an ordinary hand punch before fixing

9 Reg. 55 Art. 165.

10 Revenue Act of 1918, § 1102 (a).

11 Reg. 55, Art. 158.

12 Revenue Act of 1918, § 1104. Reg. 55, Arts. 166, 167.

the stamp to the document.[13] Where the initials of a person, firm or corporation have been perforated on the stamps before being used it is sufficient when the stamps are actually attached to the document to stamp the same with the full initials and date. Where the initials of a firm or company have been stamped or written on a stamp it is not required that the individual employee affixing the stamp shall also place his own initials thereon.[14] It has been held that stamps on promissory notes were properly cancelled when they were so used and defaced that they could never be legally used again.[15] It has also been held that the failure to write the initials of the payee's name on a promissory note, when he was affixing a stamp and cancelling the same in the presence of the court before offering the note in evidence, did not affect its sufficiency.[16] In a case decided in 1865,[17] it was held that when a bond was executed by two obligors, it was sufficient if the stamp was attached and cancelled by one of them. A stamp affixed to an instrument and cancelled can not lawfully be removed therefrom and affixed to another instrument requiring a stamp. Amounts paid for stamps used in excess, or on instruments not actually effective and for which a substitute is prepared and stamped, or on instruments not subject to tax may be refunded, upon claim properly presented to the collector.[18]

Bonds of Indebtedness. Bonds, debentures or certificates of indebtedness, however termed, issued on and after April 1, 1919,

13 T. D. 2098.

14 Letter from Treasury Department dated December 9, 1914.

15 Taylor v. Duncan, 33 Tex. (1870) 440.

16 Foster v. Holley's Adm'rs, 49 Ala. (1873) 593. The court in this case does not decide the question whether an improperly stamped note could be excluded from evidence in the state courts. See p. 819.

17 Teagarden v. Garver, 24 Ind. 399. In this case, the court says: "The object of the Act of Congress is to raise revenue, and the stamps are required to be cancelled to prevent their use a second time. This was fully accomplished by one of the obligors cancelling it, as required by the Act of Congress." The court referred to the doubtful character of the power of the federal government to make a rule excluding improperly stamped instruments from evidence in the state courts, and the court's opinion indicates that this doubt was a factor in its decision. See p. 819.

18 Reg. 55, Art. 157.

by any person,[19] are taxable at the rate of 5 cents on each $100 of face value or fraction thereof.[20]

WHERE STAMPS ARE AFFIXED. The necessary revenue stamps may be affixed either to the bonds or to the indenture under which the bonds are issued. If the stamps are affixed to the indenture, the bonds must bear a legend showing that the proper revenue stamps have been affixed to the indenture and duly cancelled. If the indenture provides for the issue of bonds over a period of years, the necessary stamps may be affixed at the time of each issue.[21] If temporary bonds or interim certificates are first issued, to be later exchanged for permanent or definitive bonds, the stamps may be affixed to the indenture, in which case a statement that the stamps were affixed to the indenture must be printed or engraved on each bond.[22] No additional tax is required on the definitive or permanent bonds which, however, should bear notation of the fact that stamps in the proper amount were duly attached to the indenture or the interim certificates.[23]

DEFINITIONS. Under the 1914 Law the tax was imposed only on bonds issued by corporations or associations. It is to be noted that the present act imposes the tax on bonds issued by persons which term includes corporations and partnerships as well as individuals.[24] There is no clear distinction between bonds of indebtedness and promissory notes, and it is sometimes difficult to determine whether an instrument should be taxed under the higher rate applying to bonds of indebtedness or the lower rate applying to promissory notes. An instrument which is styled a "bond" and which is under seal will be held subject to tax as a bond unless it is shown affirmatively that it is not a bond.[25] If the instrument is called a note but contains features not usual in or recognized as appertaining to the promissory note generally known to commerce, it is held in department practice to be taxable as a bond. Thus,

19 The term person includes partnerships and corporations as well as individuals. (Revenue Act of 1918, § 1.)

20 Revenue Act of 1918, Title XI, Schedule A-1.

21 Reg. 55, Art. 6; Letter from Treasury Department dated May 24, 1919; W. T. S. 1919, ¶ 3777.

22 Reg. 55, Art. 7.

23 T. D. 2164; T. D. 2220.

24 Revenue Act of 1918, Title XI, Schedule A-1.

25 Reg. 55, Art. 10.

under the 1914 Law it was held that an instrument designated as a "gold note" issued in the amount of $1,000 with interest coupons attached, and containing a promise by a corporation to pay a certain sum of money to the holder thereof under certain terms and conditions prescribed by the indenture of trust, was more in the nature of a bond or certificate of indebtedness than a promissory note and was, therefore, held taxable as a bond.[26] Instruments containing the essential features of a promissory note, but issued by corporations in series under a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and sometimes for redemption before maturity, or similar provisions, are held to be bonds within the meaning of the statute, whether called bonds, debentures or notes.[27] The tax applies to bonds of indebtedness executed by the obligor and delivered to a bank or trust company as security for the payment of an obligation.[28] Bonds issued by life insurance companies in satisfaction of insurance policies are subject to tax.[29]

BONDS GIVEN IN A PENAL SUM. An instrument under seal conditioned in a penal amount for the payment of a sum of money, such as often accompanies mortgages, is a bond for stamp tax purposes.[30] When a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax is based upon the amount secured and not upon the amount of the bond.[31]

BUSINESS PROPERTY INVESTMENT BONDS. Certificates commonly known as business property investment bonds are not subject to tax as bonds, debentures, or certificates of indebtedness, but are taxable as certificates of interest in property.[32]

EXEMPT BONDS. An instrument which merely represents the assignment of interest in a bond accompanying a mortgage is not

26 T. D. 2257. See definition under Promissory Notes, p. 794.
27 Reg. 55, Art. 8; T. D. 2713.
28 Reg. 55, Art. 16.
29 Reg. 55, Art. 18.
30 Reg. 55, Art. 3; T. D. 2713.
31 Revenue Act of 1918, Title XI, Schedule A-1.
32 Reg. 55, Art. 11. See pp. 754, 766.

taxable.[33] Bonds issued by school districts for school purposes are exempt from tax.[34] Certificates of deposit issued by banks and trust companies are held not to be taxable.[35]

ISSUE OF BONDS. Delivery is essential to constitute an issue of bonds.[36] It seems generally that the delivery of the bond establishes the date of issue. Thus, it was held under the 1914 Law that bonds certified and delivered by a trustee after the incidence of the tax were taxable although subscribed and paid prior thereto. Under the 1898 Law it seems to have been held that a bond was issued when delivery was made and the corporation received a benefit or a consideration therefor.[37] The date of renewal would be the date of issue for the purpose of the tax on a renewal of bonds.[38] Bonds issued by a domestic corporation in this country for sale to purchasers in a foreign country have been held to be issued here for the purpose of the tax, but bonds issued and sold by a domestic corporation in a foreign country have not been required to be stamped on the ground that the Government had no means of enforcing the statute in such case.[39] It has been ruled that bonds executed by a foreign corporation in a foreign country, certified to by a trustee in the United States, given for part of the purchase price of timber located in the foreign country, and delivered in the United States are subject to tax.[40]

TRANSFER OF BONDS. No tax is imposed upon the transfer of bonds, debentures or certificates of indebtedness from one holder to another.

RENEWAL OF BONDS. Every renewal of a bond, debenture or certificate of indebtedness is taxed as a new issue.[41] A renewal after April 1, 1919 of an instrument, issued prior thereto, will require

33 Reg. 55, Art. 12.

34 Reg. 55, Art. 19.

35 Reg. 55, Art. 13; T. D. 2054; letter from Treasury Department dated November 16, 1917; W. T. S. 1919, ¶ 3550. Such certificates were not taxed under the 1914 Law. See p. 766.

36 Reg. 55, Art. 1.

37 Volume 1, Treasury Decisions No. 20156.

38 Every renewal is taxed as a new issue. Revenue Act of 1918, Title XI, Schedule A-1.

39 Letter from Treasury Department dated May 15, 1915.

40 Reg. 55, Art. 17.

41 Revenue Act of 1918, Title XI, Schedule A-1.

the necessary revenue stamps.[42] An agreement extending a mortgage upon maturity, where a bond is secured by the mortgage and such agreement operates to renew the bond, subjects the latter to stamp tax as a renewal.[43] An agreement between the holder of a bond and the present owner of a parcel of real estate, extending maturity of a mortgage bond executed by a former owner, operates as a renewal and such renewal is subject to tax. If in addition a new bond is given for the same indebtedness, it also is subject to tax.[44]

Bonds of Indemnity and Surety. Bonds of indemnity and surety are taxed at the rate of 50 cents, but where a premium is charged for the issuance, execution, renewal or continuance of such bonds, the tax is one cent on each dollar or fractional part thereof of the premium charged. Bonds coming within this class are (a) bonds for indemnifying any person, corporation, or partnership, who shall have become bound or engaged as surety, (b) all bonds for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, (c) mortgage guarantee policies and policies guaranteeing title to real estate and (d) all other bonds of any description not otherwise provided for in Schedule A of Title XI. Policies of re-insurance are exempt from the tax imposed by this provision.[45] Mere agreements, e. g. to build houses, are not taxable, but if bonds are included for the faithful performance of the work or contracts, they are subject to tax as indemnity or surety bonds.[46] Where a premium is charged upon any bond or policy of indemnity and surety, executed or issued on or after April 1st, 1919, a statement must be made on the face of the bond or policy showing the rate and amount of premium charged, and bonding companies or other persons executing such bonds or policies must affix thereto the

[42] Reg. 55, Art. 2; letter from Treasury Department dated December 11, 1917; W. T. S. 1919, ¶ 3548.

[43] Reg. 55, Art. 4. See Appeal of C. Bolte, 18 Haw. 241; In re O. R. & L. Co., 19 Haw. 544.

[44] Reg. 55, Art. 5.

[45] Revenue Act of 1918, Title XI, Schedule A-2.

[46] Reg. 55, Art. 26.

necessary amount of stamps based upon the premium charged, cancelling the same.[47]

BONDS DELIVERED PRIOR TO INCIDENCE OF TAX. Where bonds or policies of the kind described in the preceding paragraph have been issued prior to April 1, 1919, but premiums are paid for the purpose of renewing or continuing such bonds or policies in force beyond the date of March 31, 1919, the premiums paid for such purpose are subject to tax. When premiums due and payable subsequent to March 31, 1919, are not essential to the continuance in force of such bonds, they are not taxable.[48] The renewal or continuance certificate or other papers showing the renewal or continuance of such bond or policy and the receipt or other papers showing the payment of any premium or charge for the renewal or continuance of such bond or policy must contain on the face thereof a statement showing the rate and amount of the premium charged and collected, and the bonding company or other persons issuing or executing such certificate, receipt or paper, must affix thereto the necessary amount of stamps based upon the premium charged cancelling the same.[49]

BONDS ISSUED IN FOREIGN COUNTRIES. It was held under the 1914 Law that bonds issued by guarantee companies in foreign countries guaranteeing the fidelity of individuals or corporations in the United States, executed and delivered in the foreign country, were not taxable but if they were not valid until countersigned or delivered by the agent in the United States, they should be taxed.[50]

BONDS REQUIRED IN LEGAL PROCEEDINGS. Bonds "required in legal proceedings" are exempt from stamp tax. These include attachment bonds, injunction bonds, bonds to stay proceedings, bonds on appeal or writ of error, bonds for costs, recognizances, supersedeas bonds; also official bonds of trustees, receivers, and referees in bankruptcy; and for court receivers, assignees, executors, admin-

[47] Reg. 55, Art. 24; T. D. 2825.

[48] Reg. 55, Art. 23; T. D. 2782. Under the 1914 Law it was held that a bond executed and delivered prior to the date on which the tax was first imposed, whether or not taking effect immediately or subsequent to the enforcement of the taxing act, was not subject to the tax. (T. D. 2072.)

[49] Reg. 55, Art. 25.

[50] T. D. 2051. No ruling has been issued upon this point under the 1917 or present Law.

istrators, and guardians.[51] Bonds of depositaries designated by the United States District Court for the keeping of bankruptcy estates moneys are likewise not taxable.[52]

FIDELITY AND SURETY BONDS. Fidelity and surety bonds are subject to the stamp tax.[53] Any guaranty under seal of the performance of the conditions of a contract by persons not parties thereto is taxable as a bond.[54]

AGREEMENTS TO HOLD HARMLESS, NOT UNDER SEAL AND WITHOUT SURETY. Applications addressed to surety and fidelity companies wherein the applicant agrees to indemnify the surety company in case of loss under the bond applied for, agreements executed by shippers undertaken to hold railroads harmless on account of any loss occurring by reason of the payment of claims against such railroads without the presentation of original bills of lading, etc., agreements executed by taxpayers, on banks and institutions of similar character agreeing to hold such institutions harmless on account of the payment to taxpayers of sums covered by pass-books, by checks and drafts, etc., which have been lost, and other instruments of similar character and scope not under seal and without surety which impose upon those executing them no liability other than that which would automatically be imposed upon them by operation of law, are not subject to stamp tax. It must however be clearly understood that any form of agreement or indemnification to which sureties are parties is taxable as an indemnity bond.[55]

MORTGAGE GUARANTEE POLICIES AND POLICIES GUARANTEEING TITLES TO REAL ESTATE. These policies are made expressly taxable by the 1918 Law.[56]. Under the 1917 Law, which was silent, it was held that, in common with policies of guarantee and fidelity insurance, mortgage guarantee policies and policies guaranteeing titles to real estate were subject to the stamp tax on bonds and not to the tax on insurance.[57]

[51] Reg. 55, Art. 27, T. D. 2647. It was held under the 1914 Law that bonds filed by order of the court to obtain a decree or order for the sale of real estate were exempt as bonds required in legal proceedings. (T. D. 2091.)

[52] Reg. 55, Art. 29.

[53] Fidelity and surety bonds subject to tax levied with respect to insurance policies were exempt from the stamp tax under the Senate draft of the Revenue Act of 1918, but this exemption was stricken out by the Conference Committee.

[54] Reg. 55, Art. 20.

[55] Reg. 55, Art. 31.

[56] Revenue Act of 1918, Title XI, Schedule A-2; Reg. 55, Art. 22.

[57] T. D. 2704, modifying T. D. 2588.

BONDS GIVEN TO STATES AND POLITICAL SUBDIVISIONS THEREOF. It is held on the broad ground that the sovereign states and subdivisions thereof are constitutionally free from taxation by the Federal Government, that bonds given by officials of a state, township, county or village for the faithful performance of duties, are not taxable.[58] Bonds given to a state, township, county or village for the performance of contracts, such as the construction of state or municipal buildings, or the discharge of other duties strictly for or in behalf of the state, when necessary to protect the state's interest, are held not subject to taxation.[59] A bond given as a condition to the granting of a license by a state or political subdivision is not taxable if the license is issued in the exercise of the governmental powers of the state or political subdivision.[60] Under the 1898 Law a dramshop keeper's bond, given pursuant to the laws of Missouri, as a condition precedent to the grant of a license, was not subject to tax since such bond was required under the police power of the state—a power belonging exclusively within the state's jurisdiction—and was a means or instrumentality employed by the state in the exercise of one of its most important functions.[61] It was also held under the 1898 Law that neither the separate states nor the United States have power to impose a tax which will interfere with the sovereignty of the others within their own sphere, either by taxing their functions or the means by which they are exercised; that a power in the federal government to tax the right to qualify for the performance of duties of a state office is inconsistent with the existence of any supreme governmental authority in the state; and that therefore a bond required by a state from a notary public (who was held to be an officer of the state) as a prerequisite to the exercise of his official duties is, in necessary legal effect, a tax on the officer's right to qualify and upon the exercise by the state of its governmental functions.[62] Bonds

58 Reg. 55, Art. 28. T. D. 2624. See T. D. 2111.

59 Reg. 55, Art. 28. T. D. 2624; T. D. 2072.

60 Ambrosini v. U. S., 187 U. S. 1.

61 U. S. v. Owens, 100 Fed. 70.

62 Bettman v. Warwick, 108 Fed. 46. It was also held in this case that the fact that the tax was required to be paid before the officer qualified was unimportant. See Reg. 55, Art. 28.

required by state statutes from warehousemen and owners of jitney busses running in favor of the state are not subject to the tax.[63]

Bonds Given to the Federal Government. Generally speaking bonds given to the federal government are taxable.[64] But the statute expressly provides that no bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States shall be taxed.[65] Bonds of a private corporation delivered by it to the United States Housing Corporation as collateral security for a loan to aid the borrower in performing its contract with the United States Housing Corporation are subject to stamp tax.[66] Bonds of brewers, manufacturers of oleomargarine, tobacco and cigars, also distillers' annual and warehousing bonds, and transportation bonds are required to be stamped. Where these bonds are required by law to be made in duplicate and triplicate, only the original need be stamped and on the duplicates and triplicates a memorandum must be made stating that the tax has been paid by stamp attached to the original bond. Copies of distillers' bonds forwarded to the Bureau of Internal Revenue for office use need not be stamped.[67] Bonds executed for the due execution or performance of any contract, obligation or requirement, or the duties of any office or position, and to account for money received by virtue thereof, furnished in compliance with the laws of the United States or regulations made pursuant thereto are subject to the stamp tax of 50 cents, even though United States Libery bonds or other bonds of the United States are deposited in connection therewith, with the officials having authority to approve such bonds, in lieu of surety or sureties.[68]

Building and Loan Associations. Stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and

63 Reg. 55, Art. 30.
64 T. D. 2624; T. D. 2111; Reg. 55, Art. 28.
65 Revenue Act of 1918, § 1101.
66 T. D. 2782.
67 Reg. 55, Art. 21.
68 Reg. 55, Art. 28, as amended by T. D. 2913. See Revenue Act of 1918, § 1320.

make loans only to their shareholders, are not subject to the tax.[69] This provision of the law seems to exempt stock of such associations from the tax on original issue and also from the tax on sales or transfers. Any instruments other than certificates of stock and bonds are not exempt.[70]

BONDS GIVEN BY UNITED STATES, FOREIGN GOVERNMENTS AND POLITICAL SUBDIVISIONS. All bonds given by the United States, or by any Foreign Government, or by any state, territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power are exempt from taxation.[71]

Capital Stock, Issue. Although the heading of this paragraph is that used in the statute, the language of the law is that the tax shall be imposed "on each original issue, whether on organization or reorganization, of *certificates of stock,* or of profits, or of interest in property or accumulations, by any corporation." The rate is 5 cents on each $100 of face value or fraction thereof except where the certificate is issued without face value in which case the tax is 5 cents per share unless the actual value is in excess of $100 per share, in which case the tax is 5 cents on each $100 of actual value or fraction thereof. The stamps representing this tax must be ordinary documentary stamps and are required by the law to be attached to the stock books and not to the certificates where issued.[72] Where the blank stock certificates are not kept in a stock certificate book the stamps should be affixed to the books of record in which the issue of stock is recorded.[73]

CONTRACT TO ISSUE STOCK. It has been held by the Treasury Department that no stamps are required to be affixed to a contract or agreement by a corporation to issue stock.[74] Under a later ruling, however, stock is deemed to be issued when it is subscribed for and the subscription is accepted by the corporation regardless of the

69 Revenue Act of 1918, § 1101; Reg. 40 Rev., Art. 5.

70 Under the 1914 Law it was held that notes given to or by such associations were taxable (T. D. 2112).

71 Revenue Act of 1918, § 1101. See T. D. 2072.

72 Revenue Act of 1918, Title XI, Schedule A-3; Reg. 40 Rev., Arts. 2, 3, 7, 8, 37.

73 Letter from Treasury Department dated November 20, 1917, W. T. S. 1919, ¶ 3589.

74 T. D. 2599.

time of delivery of the certificate.[75] It is to be noted that the statute fixes a tax upon the *issue* of certificates of stock, etc., and the later ruling of the Treasury Department indicated above seems to be an unwarranted construction of the act.[76]

ORIGINAL ISSUE. The tax on the issue of capital stock is laid upon an excise or privilege of the corporation employed for its benefit. The tax is laid upon the stock which a company originally issued and not upon certificates creating no addition to the total stock liability of the company. Where stock is issued with the right of conversion, and upon the exercise of this right stock of a different kind is issued to the stockholder so that in a sense the capitalization of the company is re-classified, no benefit accrues to the company and the transaction constitutes essentially nothing but an adjustment among the existing stockholders of rights which always attached to the original stock issue by virtue of the privileges of the charter of the corporation. This rule applies if a corporation issues (1) preferred stock in place of common stock, or (2) one kind of preferred stock in place of another kind of preferred stock, or (3) stock without par value in place of stock with par value, provided the total outstanding stock is not increased. In other words, upon any reorganization,[77] only an original issue creating a new and further stock liability is subject to the stamp tax upon the issue of capital stock. The tax is designed to apply to the privilege of issuing stock in return for property against which the stock is first put out as an equivalent, and not to apply to subsequent issues based upon mere conversions, subdivisions, or re-classifications of

[75] Reg. 40 Rev., Arts. 1, 33.

[76] See Malley v. Bowditch, 259 Fed. 809, in which the Court says in sustaining the constitutionality of the 1914 Law that "the stamp tax is contingent upon the original issue of a certificate of stock, just as a stamp tax on checks is contingent upon the issuing of checks."

[77] The term "reorganization" means a business arrangement whereby the stock and bonds of a corporation are readjusted as to amount, income or priority, or the issue of one kind of stock is substituted for the issue of another kind, or the property is sold to a new corporation for new stock and bonds, or is sold by foreclosure of a mortgage upon it to a purchaser who buys for himself and his associates, and includes the various proceedings and transactions by which succession of corporations is brought about, and also the proceedings by which existing corporations are continued under a different organization without the creation of a new corporation.

the original total.[78] Stock certificates issued in lieu of original certificates in a case where a corporation had changed its name are not taxable as an original issue,[79] and temporary or interim stock certificates issued before the permanent issues are taxable as original issue, but the subsequent exchange of such temporary certificates for definitive stock certificates to the same owner is not subject to any tax.[80] The issue of certificates of stock of a smaller denomination in exchange for outstanding certificates, where there is no change in ownership or in the total amount of stock issued, is not subject to tax.[81] It was held under the 1914 Law that where bonds had been issued with the privilege of exchanging same for certificates of stock and the option was exercised after the incidence of the tax, the stock certificates then issued were taxable as original issue unless prior to the incidence of the tax the certificates in question had been issued and were held in trust for the purchaser of the bonds, in which case the rate of tax on transfers of stock was applicable.[82]

[78] Reg. 40 Rev., Arts. 4 and 5; Wabash Railroad Co. v. Edwards, U. S. Dist. Ct., So. Dist. of N. Y.; W. T. S. 1919, ¶ 3962. The decision in this case was based upon the 1917 Law and overruled T. D. 2752 dated August 20, 1918, by which it was held that the tax applied in the cases stated in the text above, and also that it applied to the issue of preferred and common stock whether or not exchanged for old stock upon a reorganization of a corporation, under Section 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value. The decision would not seem to affect that part of T. D. 2752 or that part of Reg. 40 Rev., Art. 4, which ruled that the tax applied to the issue of stock of either corporation in addition to its already existing stock upon a merger of trust companies under Sections 487 to 496 of the New York Banking Law, and to the new issue of stock by a consolidated corporation in exchange for stock of the consolidating corporations. The broad statement in Reg. 40 Rev., Art. 4, that the issue of certificates of stock upon reorganization by a corporation is subject to tax, is modified by this decision. Judge Augustus Hand founds his decision largely upon the statutory rule of construction that a taxing statute is to be strictly construed against the Government and in favor of the taxpayer. (See p. 847.) And upon the further consideration that the 1917 Law was a re-enactment of a statute which had received a settled administrative construction by virtue of T. D. 20694, dated February 7, 1899, issued under the Spanish War Revenue Act of June 13, 1898, followed for many years until the enactment of T. D. 2752.

[79] Reg. 40 Rev., Art. 5.

[80] Reg. 40 Rev., Art. 5; T. D. 2584. Reg. 40 Rev., Art. 4.

[81] Reg. 40 Rev., Art. 5.

[82] T. D. 2155.

CERTIFICATES OF STOCK. The present law applies to the issue of (1) certificates of stock, (2) certificates of profit, and (3) certificates of interest in property or accumulations, issued by any corporation.[83] The 1917 Law applied only to certificates of stock. Under the 1914 Law, which taxed certificates of profit "or any certificate or memorandum showing an interest in the property or accumulations of any association, company or corporation, * * * " it was held that certificates issued by trustees to persons who had deposited certain securities, such certificates issued by the trustees showing such persons to be entitled to a part of the dividends, etc., accruing on account of the securities deposited, were taxable as certificates of profits.[84] Under the present law it seems that certificates evidencing an interest in profits or accumulations are not taxable unless issued by a "corporation," as that term is used in the law, but the Treasury Department has ruled that the issue to the beneficiary of certificates covering shares in the nature of shares of stock, where a number of persons pool their individual properties and appoint trustees having a definite term of office for the purpose of managing it and retain certain rights of control over the property and a voice in the selection of the trustees who are authorized to issue the certificates, is subject to tax.[85]

ISSUED BY ANY CORPORATION. The term "corporation," as defined in Section 1 of the law, includes associations, joint-stock companies, and insurance companies.[86] It has been held that the tax applies to the issue of certificates of shares in so-called Massachusetts trusts and other unincorporated associations.[87]

83 Revenue Act of 1918, Title XI, Schedule A-3; see Reg. 40 Rev., Art. 33.

84 Reg. 40 Rev., Art. 4; letter from Treasury Department dated July 26, 1916, W. T. S. 1916, p. 353.

85 Reg. 40 Rev., Art. 4.

86 See Reg. 40 Rev., Art. 4.

87 T. D. 2752. It has been held that the 1914 Law does not impose a franchise tax or a corporation tax but imposes a stamp or document tax; that it follows from this consideration that whether the share capital is fixed by agreement or under statutory authority is immaterial and that the tax applies to certificates of shares issued by a manufacturing company organized in the form of a trust under the common law and deriving none of its rights, benefits or qualifications from any statute, and which was not an ordinary common law real estate trust. In other words, the word "stock" is to be interpreted in connection with the accompanying words of the statute "association, company,

STOCK OF DOMESTIC CORPORATIONS. The tax attaches to the issue of certificates of stock by a domestic corporation, no matter where the certificates are actually delivered.[88]

STOCK OF FOREIGN CORPORATIONS. Certificates of stock of foreign corporations sold or delivered within the United States are subject to the same tax as certificates of stock of domestic corporations. Stock of a corporation organized in a foreign country, issued in the United States, is subject to the tax on original issue.[89]

BUSINESS PROPERTY INVESTMENT BONDS. The issue by a corporation of business property investment bonds, or other instruments, wherein it is certified that the holder thereof is the owner of an interest in specified real property the legal title to which has been previously conveyed to a trustee and whereby the corporation issuing the same agrees to manage the property and distribute the proceeds in a certain manner is subject to tax.[90]

JOINT-STOCK LAND BANKS. The issue of certificates of stock by joint-stock land banks is subject to the stamp tax.[91]

PURCHASING BUSINESS OR ASSETS. The issue by a corporation of stock in exchange for property, real or personal, or for the purpose of purchasing the business or assets of another concern, is subject to tax.[92]

STOCK DIVIDENDS AND FRACTIONAL SCRIP CERTIFICATES. The issue of stock dividends and fractional scrip certificates is subject to tax.[93]

or corporation.'' It is a term not peculiar to corporations, but equally applicable to the share capital or fund created by or in accordance with an agreement for the formation of an unincorporated association or company. The difference between corporations and unincorporated associations being immaterial to the imposition of a stamp tax on documents, the different modes of realizing on the shares by the certificate holders is also immaterial. (Malley v. Bowditch, 259 Fed. 809.) See also Crocker v. Malley, 249 U. S. 223.

88 Reg. 40 Rev., Art. 4; letter from Treasury Department dated July 24, 1918; W. T. S. 1919, ¶ 3588. This ruling was made in the case of stock issued in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba. See p. 744 as to bonds.

89 T. D. 2073.

90 Reg. 40 Rev., Art. 4.

91 Reg. 40 Rev., Art. 4.

92 Reg. 40 Rev., Art. 4.

93 Reg. 40 Rev., Art. 4.

FEDERAL LAND BANKS. The issue of certificates of stock by Federal Land banks is not subject to tax.[94]

RIGHTS TO SUBSCRIBE TO STOCK. The issue of "rights" to subscribe for the stock by any corporation, joint-stock company or association evidenced by warrants is not subject to tax.[95]

VOTING TRUST CERTIFICATES. The tax does not apply to the issue of voting trust certificates representing stock certificates already issued.[96]

MEASURE OF TAX. The tax is measured, not by the amount paid in on, or for the stock, but by the face or par value of the stock, in the case of shares having a face or par value. The tax is imposed on the face or par value of the certificate and not upon the par value of each share. Thus, a certificate representing 10 shares of a par value of $10 each would be taxable as having a face or par value of $100. In the case of shares having no face or par value the tax is measured by the number of shares represented by the certificate unless the actual value of the stock is in excess of $100 per share in which case the tax is based upon the actual value of the stock represented by the certificate regardless of the number of shares.[97]

SHARES WITHOUT PAR VALUE. The actual value of shares without par or face value is a question of fact. For the purpose of this tax it may be determined by the statement of the company and the consideration involved in the issue of such stock,[98] or may be determined by the market price or otherwise.[99]

Capital Stock, Sales and Transfers. The law provides for a tax on (a) all sales, (b) agreements to sell[100] or memoranda of

94 Reg. 40 Rev., Art. 5.

95 Reg. 40 Rev., Art. 5.

96 Reg. 40 Rev., Art. 5; T. D. 2752.

97 Reg. 40 Rev., Art. 3; see T. D. 2752.

98 Letter from Treasury Department dated November 26, 1917; W. T. S. 1919. ¶3592; Reg. 40 Rev., Art. 3.

99 T. D. 2752.

100 The term "agreement to sell" includes options, calls in "puts and calls," offers, indemnities and privileges, and contracts, either in writing or by parol, to sell on the deferred or partial payment plan (Reg. 40 Rev., Art. 33). In holding that a "call" was an "agreement to sell" under the 1898 Law the Supreme Court, in Treat v. White, 181 U. S. 264, pointed out the distinction between an "agreement to sell" and an "agreement of sale" as follows: "That there is a difference between an agreement to sell and an agreement of sale is clear. The latter may imply, not merely an obligation to sell, but an

sales or deliveries of or transfers of legal [101] title to shares or certificates of stock in any association, company or corporation.[102] The tax is imposed whether or not the stock is represented by certificates,[103] and also whether or not the sale or transfer is shown by the books of the association, company or corporation, or is made by assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock [104] or not. In the case of stock having a par or face value, the amount of the tax is 2 cents on each $100 or fraction thereof of the total par or face value of the shares or certificates involved in the sale or agreement to sell, whether such aggregate par or face value is greater or less than $100; e. g., where the total par or face of the shares involved in the transaction is $100 or less, the tax is 2 cents; where such value is in excess of $100, the tax is 2 cents on each $100 or fraction thereof. Where one certificate represents several shares (however large the number of shares) on the transfer of such certificate the tax is computed upon its face value and not on the face value of each separate share of stock, or of profits, or of interest in property or accumulations; e. g., on the transfer of one certificate representing 500 shares, par value $5, the face value of the certificate being $2,500, the stamp tax is 50 cents.[105] In the case of shares of stock without par or face value, the tax is 2 cents on the transfer or sale of, or agreement to sell, each share, unless the

obligation on the part of the other party to purchase, while an agreement to sell is simply an obligation on the part of the vendor or promisor to complete his promise of sale. That Congress recognized the difference between these two terms is evident, because in the very next paragraph of Schedule A it provides, in reference to merchandise, for a stamp 'upon each sale, agreement of sale, or agreement to sell.' That no stamp duty was imposed on agreements to buy (or, in the vernacular of the stock exchange, 'puts') furnishes no ground for denying the validity of the stamp duty on agreements to sell.''

101 The word ''legal'' was first introduced in the 1917 Law and was not contained in the Act of October 22, 1914. (See Reg. 40 Rev., Art. 33.) Cf. § 270 of the New York State Tax Law and the case of Travis v. Ann Arbor Co., 180 N. Y. App. Div. 799.

102 The law uses the word ''corporation'' but see the definition of this term in Revenue Act of 1918, § 1.

103 Reg. 40 Rev., Art. 12; T. D. 2752.

104 The Act of October 22, 1914, also read: ''or to secure the future payment of money or for the future transfer of any stock.''

105 Reg. 40 Rev., Art. 11.

actual value of such share is in excess of $100, in which case the tax is 2 cents on each $100 or fraction thereof; e. g., if the actual value of the share of stock is $25, the tax is 2 cents on each share; if the actual value of the share is $175, the tax is 2 cents on the $100 and 2 cents on the $75, being a fraction of $100, making a total tax of 4 cents.[106] The tax is measured, not by the amount paid in, on, or for, the stock but by the face or par value of the stock in the case of shares having a face or par value, and by the actual value determined by the market price or otherwise in the case of shares having no face or par value but an actual value in excess of $100 a share.[107]

AFFIXING AND CANCELLATION OF STAMPS. In the case of a sale before certificates are issued, where the evidence of transfer is shown only by the books of the corporation, the stamps should be placed on such books. In case the change of ownership is effected by transfer or delivery of the certificate, i. e., where the name of the transferee is inserted in the indorsement or power of attorney on the back of the certificate, the stamp should be affixed to such certificate and canceled by the person making the sale. In case of agreement to sell, or where the transfer is by delivery of the certificate assigned in blank, the stamp should be affixed to the bill, memorandum, or agreement to sell, and canceled by the seller. In no event should any transfer agent or corporation accept or transfer any shares of stock or certificates unless stamps for all transfer tax required thereon have been properly affixed either to the certificates of stock or memoranda of sale, as the case may be, and duly canceled. The person using or affixing the stamp should write or stamp thereon, in ink, his initials and the day, month, and year on which the same shall be affixed, or, by cutting or canceling with a machine or punch, affix his initials and the date as aforesaid, and so deface such stamp as to render it unfit for reuse. In addition to the foregoing, stamps of the value of 10 cents or more should have three parallel incisions made with some sharp instrument lengthwise through the stamp after the same has been attached to the certificate, or bill, or memorandum, or other evidence of sale or transfer, unless the stamps are canceled by perforation. The cancellation by either method should not so deface the stamp

106 Revenue Act of 1918, Title XI, Schedule A-4; Reg. 40 Rev., Art. 10.
107 T. D. 2752.

as to prevent its denomination and genuineness from being readily determined.[108]

SHARES WITHOUT PAR VALUE. The law provides that the tax shall be imposed at the rate of 2 cents a share on shares without par or face value, unless the actual value of the share is in excess of $100, in which case the tax is 2 cents on each $100 of such actual value or fraction thereof. The actual value is measured by the market price at the time of the sale or transfer, which value is considered by the Treasury Department to be the actual value.[109]

WHEN TAX ACCRUES. The stamp tax on sales or transfers of stock accrues at the time of making the sale or agreement to sell or memorandum of sale, or delivery of or transfer of the legal title to shares, or certificates of stock, or of profits, or of interest in property or accumulations in any corporation, joint-stock company, or association, or of the right to subscribe for or to receive such shares or certificates, regardless of the time or manner of the delivery of the certificate or agreement or memorandum of sale.[110]

WHERE TITLE TO THE STOCK PASSED PRIOR TO THE INCIDENCE OF THE TAX. No tax is imposed upon the transfer of such stock on the books of a corporation although made after the date on which the tax was first imposed.[111]

TAX PAID BUT ONCE. Where shares of stock are sold and the tax has been paid and stamps affixed to a bill or memorandum of sale, stamps are not again required when the transfer is made on the books of the company from the name of the party selling to the name of the purchaser.[112]

SHARES OR CERTIFICATES OF STOCK. The law imposes this tax on all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to "shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates."[113]

108 Reg. 40 Rev., A. . 37; letter from Treasury Department dated May 22, 1918; W. T. S. 1919, ¶ 3600; Reg. No. 40, Part 1, Art. 7.

109 Reg. 40 Rev., Art. 10; T. D. 2752; letter from Treasury Department dated November 26, 1917, W. T. S. 1919, ¶ 3592. See Capital Stock, Issue.

110 Reg. 40 Rev., Art. 9.

111 Letter from Treasury Department dated November 30, 1917; W. T. S. 1919, ¶ 3590. This was also the rule under the 1914 Law.

112 Reg. 40 Rev., Art. 13; T. D. 2073.

113 Revenue Act of 1918, Title XI, Schedule A-4; Reg. 40 Rev., Art. 3.

STOCK OF DOMESTIC CORPORATIONS. The tax attaches to the transfer of stock on the books of a domestic corporation, no matter where the sale is made or the stock certificates are delivered.[114]

STOCK OF FOREIGN CORPORATIONS. When certificates of stock of a foreign corporation are sold or delivered within the territorial jurisdiction of the United States they are subject to the same tax as certificates of stock of a domestic corporation.[115]

TRUSTS. The tax on the transfer of capital stock has been held to apply to the transfer of shares in so-called Massachusetts Trusts and other unincorporated associations.[116] In rulings issued under the present law it is held that the sale or transfer of certificates issued by trustees, where such trustees are appointed for a definite period and the declaration of trust provides that the beneficiaries (termed "stockholders") shall hold annual meetings for the election of new Trustees to fill the vacancies thus accruing, the beneficiaries thus reserving to themselves control over the persons delegated to conduct their affairs and a voice in the business is subject to tax; but that the sale or transfer of certificates issued by trustees, where such trustees are legally appointed for the entire period of the trust and the beneficiaries retain no substantial control over the affairs of the trust, but delegate their proprietary functions to others, any further control on their part depending upon contingencies, their rights being limited to filling vacancies caused by death, resignation or disability is not subject to tax.[117]

TRANSFER OF STOCK BEFORE ISSUE OF CERTIFICATE. The existence of a stock certificate is not essential in order to make the transfer of shares subject to the tax. A transfer affecting a change of ownership of the share, whether made before or after the issuance of the original certificates is taxable. Thus, the sale or transfer of temporary or interim certificates and the transfer of the interest of a subscriber for stock, however such interest may be evidenced or conditioned upon further payments, are subject to tax.[118] Under

[114] Reg. 40 Rev., Art. 12; letter from Treasury Department dated July 24, 1918; W. T. S. 1919, ¶ 3588. This ruling was made in the case of stock transferred in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba.

[115] Reg. 40 Rev., Art. 12; T. D. 2073.

[116] T. D. 2752.

[117] Reg. 40 Rev., Arts. 12, 13.

[118] Reg. 40 Rev., Art. 12; T. D. 2752; T. D. 2599

the 1914 Law is was held that transfers of subscription warrants entitling the holder to certificates of stock were taxable as transfers of stock.[119]

Rights to Suscribe for Stock. Under the present law, rights to subscribe for or to receive shares or certificates of stock (or of profits or interest in property or accumulations) in any corporation whether or not evidenced by warrants are expressly made subject to tax.[120]

Rights to Receive Stock Dividends. The transfer of a right to receive a stock dividend already declared is taxable.[121]

Voting Trust Certificates. It has been held that: (1) The transfer of stock from stockholders to voting trustees is subject to tax, (2) the receipt of the certificates given by the voting trustees to the stockholders is not subject to tax, (3) any sale or transfer of such voting trust certificates by the owner is subject to tax, (4) the transfer by the voting trustees to the stockholders at the termination of the voting trust agreement is subject to tax.[122]

Stockholders' Committees. A transfer of stock by individual stockholders to a committee of stockholders under a deposit agreement is subject to the stock transfer tax.[123] Transfers of certificates of stock to stockholders' committees for the protection of

119 Letter from Treasury Department dated July 8, 1915.

120 Revenue Act of 1918, Title XI, Schedule A-4; Reg. 40 Rev., Arts. 12, 33. Under the former law, it was first held that such rights were included in the definition of the term ''share or shares of stock'' (Letter from Treasury Department dated March 12, 1915) and later that the tax did not apply to the transfer of rights to subscribe for stock prior to the exercise thereof and actual subscription (Reg. No. 40, Part I, Art. 1; T. D. 2752). It was held under the 1914 Law that transfers of such rights were not taxable. It has been held under Section 270 of the New York State Tax Law that the transfer of a certificate of subscription to additional corporate stock to be paid for in installments and subject to forfeiture for non-payment, upon the payment of all of which the certificate is to be issued, and under which the holder receives interest upon the moneys actually paid, but is not entitled to vote as a stockholder or participate in dividends is not taxable. (Sohmer v. Hebden, 165 N. Y. App Div. 853.)

121 Reg. 40 Rev., Art. 12; T. D. 2752.

122 Reg. 40 Rev., Art. 12; Reg. No. 40, Part 1, Art. 1; letter from Treasury Department dated May 22, 1918; W. T. S. 1919, ¶ 3600. See letter from Treasury Department, dated January 7, 1915, for rulings as to voting trust certificates under the 1914 Law.

123 Letter from Treasury Department dated April 30, 1918; W. T. S. 1919, ¶ 3598.

stockholders pending the receivership of a corporation are subject to tax.[124]

LOAN OF CERTIFICATES OF STOCK. The transfer of shares or certificates of stock in any corporation made by the person loaning stock to another borrowing the stock to effect a sale, and also the transfer of shares or certificates of stock from a borrower returning them to a lender in fulfilment of the borrower's obligation to buy in and return stock, are both subject to tax.[125] In a so-called short sale transaction there are therefore four taxable sales or transfers: (1) The sale of stock by the person making the short sale; (2) The transfer from the lender of stock to the person making the short sale so that he may make delivery of the stock sold; (3) The purchase by the borrower of stock to return to the lender; (4) The transfer from the borrower to the lender of shares to replace those borrowed.[126]

TRANSFERS TO AND BY FIDUCIARIES. Transfers of legal title are taxable, whether or not the transferee acquires any beneficial interest in the stock transferred. Thus, transfers from one trustee to another trustee under the same trust are subject to tax[127] and transfers from an executor or administrator to a trustee, and transfers from a trustee to the beneficiary under the trust are taxable, under the present law.[128] Transfers, however, of stock standing in

[124] Letter from Treasury Department dated January 28, 1919; W. T. S. 1919, ¶ 3599.

[125] Reg. 40 Rev., Art. 12.

[126] T. D. 2685. Under the 1914 Law, certificates so loaned were not held taxable. (T. D. 2182.)

[127] Reg. 40 Rev., Art. 12; letter from Treasury Department dated July 12, 1918; W. T. S. 1919, ¶ 3601.

[128] Reg. 40 Rev., Art. 12; letter from Treasury Department dated July 1, 1919; W. T. S. 1919, ¶ 3974. Under the 1914 Law it was held that transfers from a deceased to his executor or administrator were not taxable. Transfers from a trustee to a substitute trustee were not taxable. Transfers from an executor or administrator to a trustee were taxable as were also transfers from the trustee to the beneficiary under the trust. It is to be noted that the words "legal title to" have been added to the Act of October 3, 1917 (see note 101 of this chapter), and therefore the fact that the trustee or nominee who transfers stock, and the party to whom title is transferred, both represent the same estate or beneficiary, does not affect the question, so long as the *legal title* is transferred. (Letter from Treasury Department dated July 12, 1918; W. T. S. 1919, ¶ 3601.)

the name of a deceased person to his executor or administrator are not taxable.[129]

TRANSFERS TO OR BY ALIEN PROPERTY CUSTODIAN. A transfer to the Alien Property Custodian of shares or certificates of stock in an American corporation in compliance with a demand made by him under authority of the Trading With the Enemy Act is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the Government and is therefore held not subject to the stamp tax. A sale by the Alien Property Custodian of shares or certificates of stock under the authority of the Trading with the Enemy Act, his agreement so to sell, and his transfer of legal title to certificates or shares so sold by him are held to be governmental acts in the administration of the Trading with the Enemy Act and therefore not subject to the stamp tax.[130]

BROKERS' INDIVIDUAL SALES. The sale, or agreement to sell, shares of stock made by a broker, directly or indirectly, for himself, and the sale or transfer of stock by a broker at a price different from that at which he accounts to his selling customer, are subject to tax.[131]

GIFTS. The transfer of stock in pursuance of a gift, bequest, or conveyance by trustees is subject to the tax.[132]

OTHER TRANSFERS WHERE CHANGE OF LEGAL TITLE ONLY TAKES PLACE. It has been recently held under the Stock Transfer Tax Law of New York (the language of which is similar to that of the federal law) that stock transfer taxes accrue upon the cancellation and surrender of a stock certificate standing in the name of an accommodation holder (nominal stockholder) and the making out of a new certificate in the place thereof in the name of another accommodation holder, and the endorsement of the new certificates in blank by the latter, the actual ownership of the stock at all times remaining in the same person. As there were two transfers of the legal title, two taxable transfers took place and a tax was required to be paid on each.[133]

129 Reg. 40 Rev., Art. 13; letter from Treasury Department dated July 1, 1919; W. T. S. 1919, ¶ 3974.

130 Reg. 40 Rev., Art. 13; T. D. 2786.

131 Reg. 40 Rev., Art. 12.

132 Reg. 40 Rev., Art. 12.

133 New York State Tax Law, § 270. Travis v. Ann Arbor Co., 180 N. Y.

FORMAL TRANSFERS WHERE NO CHANGE OF TITLE TAKES PLACE. The statute does not contemplate a tax unless there is a transfer of *legal* title to shares or certificates. Therefore, the tax on transfers of stock is not applicable to the surrender of old stock in exchange for new stock pursuant to a reorganization of a corporation.[134] The tax on transfers of stock does not attach to the exchange of stock certificates of the merged corporation for stock certificates of the merging corporation at the time and as a part of the merger nor to the substitution of new certificates for certificates representing old stock of the merging corporation.[135] Where, however, as under Section 15 of the New York Stock Corporation Law, providing for the merger of ordinary corporations, the acquisition of the stock of the corporation to be merged is a condition precedent to the merger, then the transfer of such stock to the merging corporation prior to the actual merger is taxable.[136] In the case of a consolidated corporation issuing stock in exchange for the stock of consolidating corporations the surrender of the stock of the consolidating corporations in exchange for the stock issued by the consolidated corporation is not a taxable transfer.[137] The tax does not apply to the surrender of certificates in exchange for other certificates representing the same or new stock, provided they are issued to the same holder,[138] but the tax attaches to the surrender of common stock certificates in exchange for preferred stock certificates or vice versa without change of ownership.[139]

STOCK REDEEMED BY THE ISSUING CORPORATION. The tax on the transfer of capital stock does not apply to the surrender of stock certificates for retirement and redemption for cash. If, however, the corporation buys some of its own stock and transfers it to

App. Div. 799. The court said in this case: "The application of any other rule would be opposed to the plain wording of the statute, and furnish in many cases an easy method of evasion of the tax."

134 Reg. 40 Rev., Art. 13; T. D. 2752; letter from Treasury Department dated June 10, 1916. This is true in the case of a reorganization under Section 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value. For a definition of the term "reorganization" see note 77.

135 Reg. 40 Rev., Art. 13; T. D. 2752. This is true in the case of a merger of trust companies under Sections 487 to 496 of the New York Banking Law.

136 T. D. 2752; Reg. 40 Rev., Art. 12.

137 Reg. 40 Rev., Art. 13; T. D. 2752.

138 Reg. 40 Rev., Art. 13; T. D. 2752.

139 Reg. 40 Rev., Art. 12.

itself, whether or not it intends eventually to cancel it, the transfer to the corporation is subject to tax. The test is whether the immediate transaction results in the extinction of the stock or investing title to it in the corporation.[140]

DEPOSIT OF STOCK CERTIFICATES AS COLLATERAL SECURITY. No tax is intended to be imposed upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer or retransfer for such purpose of such stock certificates so deposited. In each such case, however, the person making a transfer of such certificates as collateral security must make and sign a statement of the facts and attach it to the certificate.[141] Under the 1914 law it was held that no tax was imposed on stock deposited as collateral until complete title to the certificates of stock was acquired by the pledgee.[142] This seems also to be the rule under the present law.

TRANSFERS TO OR BY A BROKER. No tax is imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased the same, but such deliveries or transfers must be accompanied by a certificate setting forth the facts.[143]

CERTIFICATE BY BROKER. The following forms have been prescribed for the use of brokers: (a) (in the case of a transfer to a broker) "We hereby certify that we have no ownership or interest, in * * * shares of the stock above transferred, the transfer by the owner to us being merely for the purpose of sale," (b) (in the case of a transfer by a broker) "We hereby certify that the transfer of * * * of the within shares to the names indicated by the star is made solely to complete the purchase made by us for

140 Reg. 40 Rev., Arts. 12, 13; T. D. 2752; letter from Treasury Department dated June 20, 1918; W. T. S., 1919, ¶ 3597. Under the 1914 Law it was held that where stock was redeemed by a corporation the transfer from the stockholder to the corporation was subject to tax whether or not the stockholder merely surrendered the certificate for cancellation or executed the assignment on the back of the certificate. (Letter from Treasury Department dated January 20, 1916.)

141 Revenue Act of 1918, Title XI, Schedule A-4. See Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5.

142 Letter from Treasury Department dated December 28, 1915.

143 Revenue Act of 1918, Title XI, Schedule A-4; Reg. 40 Rev., Art. 13.

our customer, and we have no ownership or interest therein." No broker who has filed a certificate under the foregoing clause (a) of this ruling should file a certificate under the foregoing clause (b) with reference to the transfer of any shares of stock covered by the certificates filed by him under clause (a).[144]

TRANSFER TO CLEARING HOUSE. No tax is imposed upon transfers or deliveries to a clearing house for the sole purpose of clearing or adjusting accounts between members, where no beneficial interest is vested in said clearing house or clearing association and there has been no change of title or interest.[145]

INCONSISTENT BY-LAWS, RULES, OR CUSTOMS OF EXCHANGE. No provisions, by-laws, rules or customs of any exchange or similar institution inconsistent with any requirement or provision of the Revenue Act of 1918 or any regulations made thereunder, nor any collateral additional agreement or understanding, either verbal or written, respecting the subject matter of sales or transfers of certificates, or the settlement or fulfillment thereof, which are inconsistent or in conflict with any requirement of said act or regulations will exempt any person from the payment of the tax imposed on sales or transfers of stock.[146]

SALE OF STAMPS. The ruling of the Treasury Department in regard to the sale of stock transfer stamps is given elsewhere in this book.[147]

REGISTRATION OF STOCK BROKERS. Stock brokers, transfer agents and clearing houses are required to register with the collector of internal revenue and to keep records of sales and transfers as is more fully set forth in a subsequent part of this chapter.[148]

Certificates of Profits. The 1898 Law and the 1914 Law taxed the original issue of a "certificate of profits, or any certificate or memorandum showing an interest in the property or accumulations of any association, company, or corporation, and on all transfers thereof." The 1917 Law was silent. The present law

144 Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5.

145 Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5. A clearing house need not be incorporated and may be a part or department of an exchange or an independent body (Reg. 40 Rev., Art. 33). See p. 803.

146 Reg. 40 Rev., Art. 14.

147 See pp. 807, 815.

148 See pp. 802, 813.

taxes the original issue of "certificates of * * * profits, or of interest in property or accumulations, by any corporation"[149] and the sale or transfer of legal title to "certificates * * * of profits or of interest in property or accumulations in any corporation."[150] In the 1918 Law the term "corporation" includes associations, joint-stock companies, and insurance companies. It seems, therefore, that certificates of profits or interest in property or accumulations are not taxed on original issue unless issued by a corporation, association, joint-stock company or insurance company, but the sale or transfer thereof may be taxed, if the certificate evidences an interest in the profits, property or accumulations of a corporation, association, joint-stock company or insurance company, regardless of who may have issued it. Thus, voting-trust certificates are not taxable on original issue, if they are issued by a trustee, but are subject to the tax on transfers when sold or transferred by the owner.[151] Under the 1914 Law it was held that certificates issued by trustees to persons who had deposited certain securities, showing such persons to be entitled to a part of the dividends accruing on account of the securities deposited were liable to the tax upon certificates of profit.[152]

BUSINESS PROPERTY INVESTMENT BOND. A business property investment bond wherein it is certified that the holder thereof is the owner of an interest in certain specified real property, legal title to which has previously been conveyed to a trustee, and whereby the corporation issuing the same agrees to manage the property and distribute the proceeds in a certain manner, is not subject to tax as a bond, debenture, or certificate of indebtedness, but as a certificate of interest in property.[153]

Certificates of Deposit. A certificate of deposit is not subject to tax as a promissory note.[154] Certificates of deposit issued by banks and trust companies are not considered to be taxable as certificates of indebtedness, whether or not they are time certif-

149 Revenue Act of 1918, Title XI, Schedule A-3.

150 Revenue Act of 1918, Title XI, Schedule A-4.

151 Reg. 40 Rev., Arts. 5 (e), 12 (d). See, however, Reg. 40 Rev., Art. 4 (b), and the discussion upon this point at pp. 753, 755, 760, 802.

152 Letter from Treasury Department dated July 26, 1916.

153 Reg. 55, Art. 11.

154 Reg. 55, Art. 62.

icates, or contain a clause reserving the right of thirty days' notice of payment.[155]

MORRIS-PLAN BANKS. Any instrument which is actually a certificate of deposit issued by a bank is exempt from stamp tax, regardless of whether it is negotiable or non-negotiable or whether it is payable on demand or at some specified time. Certificates of deposit issued by banks or organizations operating upon the Morris plan are not subject to stamp tax.[156]

Certificates of Indebtedness. A "certificate of indebtedness" is primarily any instrument acknowledging liability for the payment of money, not in the recognized form of a promissory note or bill of exchange.[157] The term "certificates of indebtedness" includes only instruments having the general character of investment securities, as distinguished from instruments evidencing debts arising in ordinary transactions between individuals.[158] See bonds of indebtedness.

SCRIP-DIVIDEND CERTIFICATES OR WARRANTS. Scrip-dividend certificates or warrants are taxable as certificates of indebtedness.[159]

CERTIFICATES OF INDEBTEDNESS ISSUED BY RECEIVERS. A certificate of indebtedness issued under order of a Federal court by a receiver is subject to tax.[160]

CONDITIONAL BILLS OF SALE. Conditional bills of sale used in sale of merchandise on the installment plan are not certificates of indebtedness within the meaning of the law, and are not subject to stamp tax, unless in the form of promissory notes.[161]

Certificates Generally. No tax is imposed under the present law on certificates of incorporation, certificates of damage and certificates generally.

Checks. No tax is imposed on checks payable at sight or on demand. Only drafts or checks expressly payable otherwise than at sight or on demand are taxable.[162] See promissory notes.

155 Letter from Treasury Department dated November 16, 1917; W. T. S. 1919, ¶ 3550.

156 Reg. 55, Art. 13.

157 T. D. 2713.

158 T. D. 2919.

159 Reg. 55, Art. 9.

160 Reg. 55, Art. 15.

161 Reg. 55, Art. 14.

162 Reg. 55, Art. 63.

Contracts. No tax is imposed by the present law on contracts as such.[163]

Conveyances. The law taxes any deed, instrument or writing, whereby any lands, tenements, or other realty *sold* shall be granted, assigned, transferred or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons by his, her or their direction. The tax is based upon the consideration or value of the interest or property conveyed, exclusive of the value of any lien or incumbrance *remaining thereon at the time of sale.*[164] The rate is as follows: When such consideration or value does not exceed $100, no tax; exceeding $100 and not exceeding $500, 50 cents; for each additional $500 or fractional part thereof, 50 cents. The tax does not apply to any instrument or writing given to secure a debt.[165]

WHO AFFIXES STAMPS. The person who makes, signs or issues the deed (i. e., the grantor) is required to affix the stamps thereto and becomes primarily liable to penalty if stamps in a sufficient amount based upon the actual value of the consideration given are not so affixed.[166] The law also prohibits any person from accepting such instruments unless they are properly stamped. The grantee in a deed is liable for the tax as well as the grantor.[167] Where a purchaser has accepted an unrecorded deed he may be compelled to pay the required tax before having the deed recorded, or prosecuted under Section 1102 of the law.[168] In a case where the referee at a foreclosure sale did not affix the stamps required by law but the purchaser affixed such stamps under protest before recording the deed, it was held that the grantee, vendee or any other person participating in the making or issuing of a paper without revenue stamps may be required to pay the tax thereon and is liable for failure to do so.[169]

163 T. D. 2599.

164 Revenue Act of 1918, Title XI, Schedule A-7. See Central Trust Co. v. Columbus, etc., Co., 92 Fed. 919.

165 Revenue Act of 1918, Title XI, Schedule A-7.

166 Reg. 55, Art. 66; T. D. 2115; T. D. 2283.

167 Reg. 55, Art. 66.

168 See p. 817. See letter from Treasury Department dated May 27, 1918; W. T. S. 1919, ¶ 3717.

169 T. D. 2310; Home Title Insurance Company v. Keith, 230 Fed. 905.

WHERE STAMPS ARE AFFIXED. The stamps should be affixed on the deed or other instrument conveying the real estate.[170]

WHEN TAX ACCRUES. The time of delivery of a deed conveying real estate determines its taxability. Deeds executed and delivered on or after April 1, 1919, conveying property in pursuance of a contract made prior to that time are taxable, and deeds executed and delivered prior to such date are not taxable,[171] even though they are recorded after that rate.[172] The same rule applies to similar deeds delivered prior to April 1, 1919, and taxable under the 1917 Law. A deed dated prior to April 1, 1919, but delivered subsequent to that date, is taxable. If delivered between December 1, 1917, and April 1, 1919, it is taxable under the 1917 Law.[173] Deeds in escrow become subject to stamp tax upon delivery to the grantee. If delivered between December 1, 1917, and April 1, 1919, they are taxable under the 1917 Law; if delivered on or after April 1, 1919, they are taxable under the Revenue Act of 1918.[174] Deeds delivered after the incidence of the tax must be stamped although they may have been dated, executed and acknowledged prior thereto and even though delivered prior thereto to a third party for account of the grantee named in the deed, if delivery by such party to the grantee is made after the incidence of the tax.[175] A conveyance of property subject to an equity of redemption is taxable when made, not when the time for the equity of redemption has expired.[176]

CONSIDERATION OR VALUE. The tax is imposed upon the full amount of consideration or value although payments may have been made upon the installment plan prior to the incidence of the tax.[177] When the consideration for a conveyance of lands, tenements or other real property is left open, to be fixed by future contingencies, the actual value at the time of conveyance is the measure of the tax upon the deed, instrument or writing whereby the conveyance is made.[178] Quit-claim deeds are taxable according

170 Reg. 55, Art. 68; T. D. 2599.
171 Reg. 55, Art. 71; T. D. 2115.
172 T. D. 2115.
173 Reg. 55, Art. 72.
174 Reg. 55, Art. 73. T. D. 2115; Vol. 2, T. D. (1898) No. 20,096.
175 T. D. 2042.
176 Reg. 55, Art. 73.
177 T. D. 2279.
178 Reg. 55, Art. 67.

to the value of the interest conveyed.[179] Stock in a corporation is a valuable consideration for the transfer of real property, and a deed conveying real estate to a corporation for such consideration is taxable.[180] A conveyance of real estate by co-owners to a corporation organized for convenience in handling the property, made in consideration of the issue to them of the corporation's capital stock, is subject to tax.[181] A deed from a corporation, the entire capital stock of which is owned by another corporation, conveying real estate to the latter in consideration of the payment by the grantee of all obligations of the grantor is subject to tax.[182] The value of the interest in the property conveyed determines the amount of the tax.[183] A conveyance of land in consideration of life maintenance is taxable, the tax to be measured by the value of the property or interest conveyed.[184] Where a deed states that the transfer is made for a nominal consideration the tax must be computed upon the actual value of the interest or property conveyed.[185] Conveyances of realty, not in connection with a sale, to trustees or other persons without consideration are not taxable.[186] Taxes and assessments which have become a lien on real estate by operation of statute and which are not paid at the time of sale are deductible from the consideration in computing the stamp tax.[187] Where a parent company decided to dissolve some of its subsidiaries and to take over their real property, deeds of conveyance having been prepared for a nominal consideration, no actual consideration passing to the subsidiary companies, it has been ruled that such deeds are not subject to stamp tax.[188]

REALTY SOLD. The law provides that deeds whereby any realty sold shall be conveyed to another are taxable. Hence, it seems that if the realty is not sold, no stamps need be affixed to the deed.

179 Reg. 55, Art. 82; T. D. 20,232.
180 Reg. 55, Art. 81.
181 Reg. 55, Art. 101.
182 Reg. 55, Art. 107.
183 T. D. 2278.
184 Reg. 55, Art. 79.
185 T. D. 2115.
186 Reg. 55, Art. 95.
187 Reg. 55, Art. 109.
188 Letter from Treasury Department dated April 18, 1919; W. T. S. 1919 ¶ 3770.

The word "sold" is used in its ordinary and popular meaning,[189] and imports the transfer of the absolute or general title for a valuable consideration or price.[190] Deeds on an exchange of property are, however, subject to tax which should in each case be computed on the basis of the actual value of the interest on the property conveyed, the amount of any preexisting lien or encumbrance which is not removed by the sale being deductible.[191] Deeds that are only confirmatory and which do not vest title not already vested are not taxable.[192] The following kinds of deeds are also not taxable; (1) quit-claim deeds given for no consideration, or merely for the nominal consideration of $1.00, for the purpose of correcting flaws in title,[193] (2) partition deeds which are operative in defining boundary lines or in showing by location the interests of the tenants-in-common,[194] unless a consideration passes between the parties by reason of one or more of them taking under the division a share of real estate of greater value than his individual interest, in which event stamp tax attaches to the deeds conveying such greater shares, calculated upon the value of such consideration, (3) deeds of release,[195] (4) deeds of trust,[196] (5) deeds issued to cover pure and *bona fide* gifts of property from husband to wife or from parent to child, or from an individual to a municipality or other political subdivision, or to the United States, wherein the consideration named is "natural love and affection and $1.00," "desire to promote public welfare and $1.00," or "$1.00 and other valuable consideration,"[197] (6) deeds not granting, assigning, transferring or conveying to the purchasers any lands, tenements, or other realty, but only the right to sepultre or burial, to erect monuments, etc.,[198] (7) deeds of reconveyance by an agent to an undisclosed principal if no consideration, or a nominal considera-

189 See p. 840.
190 Reg. 55, Art. 70.
191 Reg. 55, Art. 75; T. D. 2599; T. D. 2111.
192 Reg. 55, Art. 97; Circular No. 503, 2d revision. Compilation of decisions for year 1899, p. 293.
193 Reg. 55, Art. 82; T. D. 2115.
194 T. D. 2115.
195 Reg. 55, Art. 84; T. D. 2115.
196 Reg. 55, Art. 84; T. D. 2115.
197 Reg. 55, Art. 88; T. D. 2115.
198 Reg. 55, Art. 87; T. D. 19,838

tion of $1.00 only is given,[199] (8) deeds executed by debtors covering assignments of property to trustees to be held for the benefit of creditors,[200] (9) deeds given by a husband and wife to a "straw man" who immediately executes a deed reconveying the property to the husband or wife, if no valuable consideration, or merely the nominal consideration of $1.00 is given, and likewise the deeds of reconveyance,[201] (10) deeds transferring title to property to building and loan association for the purpose of securing a loan on the property so conveyed, which property is immediately reconveyed to its owner, and likewise the deeds of reconveyance,[202] (11) conveyances of property of a copartnership, in the hands of receivers, back to the owners after administration of the estate,[203] (12) deeds by an executor to devisees, conveying specific parcels of real estate, devised to them in common, unless a consideration passes between the devisees by reason of some of them taking a greater share in the real estate than that to which entitled under the will, in which event tax attaches to the deeds conveying such greater shares, and is calculated upon the amount of value of such consideration,[204] (13) conveyances to a trustee without valuable consideration or from a trustee to a certain trust without valuable consideration;[205] (14) a conveyance of real estate by a corporation without valuable consideration to an owner of all its capital stock in consequence of its dissolution.[206] Where an officer of a corporation purchases real estate from the corporation, conveyance being first made to a third party as part of the same transaction, the property is conveyed by the third party to the officer, the conveyance to the third party is subject to tax, while the conveyance from the third party is not subject to tax.[207]

199 T. D. 2115; Reg. 55, Art. 92.

200 Reg. 55, Art. 89; T. D. 2115. When, however, the trustee sells or conveys such property either to the creditor, or any other person, the deeds executed by him are taxable. Reg. 55, Art. 89; T. D. 2115.

201 Reg. 55, Art. 91; T. D. 2115.

202 Reg. 55, Art. 90; T. D. 2115. But deeds to building and loan associations are taxable. (Reg. 55, Art. 80.)

203 Reg. 55, Art. 93.

204 Reg. 55, Art. 102.

205 Reg. 55, Art. 105.

206 Reg. 55, Art. 103.

207 Reg. 55, Art. 110.

INCUMBRANCE ON PROPERTY AT THE TIME OF SALE. The consideration or value on which the tax is based is exclusive of the value of any lien or incumbrance *remaining* thereon *at the time of sale*. The words in italics were not contained in the former law and were inserted to limit the exclusion to liens or incumbrances other than purchase money mortgages. In determining the amount of incumbrances upon real estate being transferred, no consideration is to be given to new incumbrances placed upon same at the time of, or after, the sale. Incumbrances placed on the property in connection with and as a result of the sale or transfer, as well as notes for deferred payments, cannot be deducted in determining the amount on which the tax is calculated. Only incumbrances which rest on the property before the sale and which are not removed by the sale are to be taken into consideration.[208]

ABSTRACTS OF TITLE. Abstracts of title are not taxable.[209]

CONTRACTS TO CONVEY. A contract for the sale of real estate, making provision for future delivery by deed, is not subject to stamp tax.[210]

MINING DEEDS. Deeds conveying mines are taxable.[211] A conveyance of a mine located on unpatented land is subject to taxation.[212] This ruling was made under the 1898 Law. Under the 1914 Law, it was held by the Treasury Department in an informal ruling that deeds to mining claims prior to the issue of the patent were taxable upon transfer as conveyances of real property. The tax should be computed upon the interest in the property conveyed which would be the market value of the stock issued therefor, or if it had no market value, the cash value of the mining claim.[213]

CONVEYANCE BY MORTGAGOR TO MORTGAGEE. A conveyance by a defaulting mortgagor to the mortgagee in consideration of the cancellation of mortgage debt is subject to tax calculated upon the amount of the mortgage debt plus unpaid accrued interest.[214]

TIMBER DEEDS. Standing timber is ordinarily held to be real estate. The question of whether or not a particular instrument of

[208] Reg. 55, Art. 68; T. D. 2599.
[209] Reg. 55, Art. 99.
[210] Reg. 55, Arts. 83, 98; T. D. 2599; T. D. 2115.
[211] Reg. 55, Art. 77.
[212] Vol. 1, Treas. Dec. (1899), No. 20,986.
[213] Letter from Treasury Department dated August 3, 1916.
[214] Reg. 55, Art. 104.

grant is taxable depends on whether or not the subject matter of the grant is real estate. What is real estate is determined by the law of the state in which the property conveyed is situated.[215] It is held that a timber deed transferring timber upon a tract of land is a deed of realty and as such is taxable, unless timber is not real estate under the laws of the state in which the property is located.[216]

LEASES. Leases of real property are not subject to tax.[217] Operating leases of oil and mining properties, long-term mining leases, etc., which in themselves convey no title to or interest in real property, are exempt from taxation.[218]

OPTIONS. No tax is imposed upon an option for the purchase of real property.[219]

DEEDS GIVEN BY AND TO UNITED STATES AND POLITICAL SUBDIVISIONS. Deeds executed by the United States or by any state, county, town or other municipal corporation, are not taxable.[220] Deeds executed by a state, county, or municipal officer conveying realty sold for non-payment of taxes are not subject to tax.[221] Deeds conveying to a state real estate purchased by it are not subject to tax.[222] A conveyance of real estate sold to the United States Government is subject to tax.[223]

DEEDS GIVEN BY OFFICERS OF COURTS. Stamps should be attached to masters' deeds made pursuant to decrees of the United States District Courts. The execution of such conveyances is not a judicial function, the title to the land being conveyed to the purchaser at the foreclosure sale through the master instead of the defendant himself making the sale. The cost of such stamps should be taxed as a part of the cost of the case.[224] The stamp

215 Reg. 55, Art. 76.

216 Letter from Treasury Department dated Feb. 15, 1918; W. T. S. 1919, ¶ 3714.

217 Reg. 55, Art. 100.

218 T. D. 2155, T. D. 2599.

219 Reg. 55, Art. 83; T. D. 2115.

220 T. D. 2283. See Revenue Act of 1918, Section 1101.

221 Reg. 55, Art. 85.

222 Reg. 55, Art. 86.

223 Reg. 55, Art. 106.

224 T. D. 2111, T. D. 2253; Crawford v. New South Farm and Home Co., 231 Fed. 999. This case was decided under the 1914 Law and it was held that the decision in Farmers Loan and Trust Company v. Council Bluffs Gas and Electric Company, 90 Fed. 806, decided under the 1898 Law, was applicable.

tax on a deed of real property executed by a sheriff, referee, or commissioner to a mortgagee who bids in a property at a foreclosure to satisfy the mortgage should be computed upon the amount bid for the property, plus the costs if paid by the purchaser.[225] Deeds executed by masters in chancery, sheriffs, clerks of courts, etc., to cover transfers of property sold under a foreclosure or execution are subject to tax. The grantee or vendee may be required to pay the tax or cost of revenue stamps may be included in the expense of the foreclosure sale.[226] Judgments or decrees of the State court operating to transfer title to real estate are not taxable as conveyances.[227]

CONVEYANCE TO OR BY ALIEN PROPERTY CUSTODIAN. A conveyance of realty to the Alien Property Custodian in compliance with a demand made by him under authority of the Trading with the Enemy Act, is held not subject to the stamp tax for the reason that such a conveyance is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the government, and for the further reason that it is not a conveyance of "realty sold." A conveyance by the Alien Property Custodian of realty sold by him under authority of the Trading with the Enemy Act is held not to be subject to the stamp tax for the same reason, and for the further reason that it is an instrument issued by the United States in the exercise of a strictly governmental function.[228]

PROPERTY IN A FOREIGN COUNTRY. A deed conveying real estate lying in countries which are not United States territory is not subject to tax although the grantor and grantee may both be citizens and residents of the United States.[229]

Debentures. The term "debenture" ordinarily, although not necessarily, refers to an unsecured bond.[230] See bonds of indebtedness.

Drafts. Drafts drawn at sight or on demand are not taxable.[231] But drafts drawn otherwise than on sight are generally taxable.

225 Reg. 55, Art. 69.

226 Reg. 55, Art. 74.

227 Reg. 55, Art. 108.

228 T. D. 2786.

229 Reg. 55, Art. 96; Volume 2, Treasury Decision (1898) No. 21,562. This was also the rule under the act of October 22, 1914.

230 T. D. 2713.

231 Revenue Act of 1918, Title XI, Schedule A-6. Reg. 55, Art. 33.

The taxability of a draft is determined by the face or form of the instrument and not by any understanding between the maker and the drawee.[232] For the rate of tax and a discussion of the rulings regarding taxable drafts see Promissory Notes.

Entry for Withdrawal of Goods or Merchandise from Customs Bonded Warehouse. The tax on instruments of this character is 50 cents.[233] Under the 1914 Law it was held that withdrawals for exportation were not taxable in view of the constitutional provision prohibiting taxation upon exports.[234] It was also held that where entries were filed in duplicate, triplicate, etc., a stamp was required on the original only.[235]

Entry of Goods, Wares or Merchandise at Customhouse. The law provides that entry of any goods, wares or merchandise at any customhouse, either for consumption or warehousing, shall be taxed as follows: Not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, one dollar.[236] Customhouse entries made by United States officials traveling as such on Government funds are not taxable. Likewise entries made by all representatives of foreign countries in their official capacity are by comity exempt.[237]

Foreign Insurance Policies. A tax of 3 cents on each dollar or fractional part thereof of the premium charged is imposed on each policy of insurance or certificates, binder, covering, note, memorandum, cablegram, letter or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including trans-shipments and storage at termini or way points) or by fire, lightning, tornado, windstorm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United

232 See p. 795.

233 Revenue Act of 1918, Title XI, Schedule A-9; Reg. 55, Art. 112.

234 T. D. 35,007. See U. S. v. Hvoslef, 237 U. S. 1, and paragraph on Constitutionality of Stamp Taxes.

235 T. D. (Customs) 35,040. See Wright v. Michigan Central Co., 130 Fed. 843.

236 Revenue Act of 1918, Title XI, Schedule A-8.

237 Reg. 55, Art. 111. It was so held under the 1914 Law. (T. D. Customs, 3572.)

States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a State, Territory, or district of the United States within which such insurer is authorized to do business. Policies of re-insurance are exempt from this tax.[238] It is probably not anticipated that any considerable revenue will be collected by virtue of this tax, and it seems to be intended to compel non-resident foreign corporations and partnerships and non-resident individuals, in respect to policies of insurance on property within the United States issued to domestic corporations or resident partnerships or individuals, to pay the lower tax on insurance policies imposed by Section 503 of the Revenue Act of 1918, which they have hitherto been escaping.

DEFINITIONS. The following terms are defined as indicated below: (a) "insurer" includes any person, copartnership, association, or corporation transacting the business of insurance, and also any agent or broker, wherever applicable; (b) "insurance" includes every manner of providing indemnity against risks upon property of any description (including rents and profits) from peril by sea or inland waters or in transit on land (including transshipments and storage at termini or way points) or by fire, lightning, tornado, windstorm, bombardment, invasion, insurrection, or riot; (c) "policy of insurance" includes any instrument by whatever name the same is called whereby insurance is made or renewed by the insurer, as policies, binders, certificates, open policies, covering notes, memoranda, cablegrams or letters; (d) "other instrument" includes any instrument by which insurance is made or renewed, i. e., by which the relationship of insurer and insured is created or evidenced, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called; (e) the expression "whereby insurance is made or renewed" includes any evidence or confirmation of a binding contract of insurance whereby a risk is assumed by the insurer; (f) "issue" means the act whereby insurance is made or renewed or in any manner becomes a binding contract effective for insurance; (g) "premium charged" means the total premium payable during the life of a contract

[238] Revenue Act of 1918, Title XI, Schedule A-15.

of insurance and shall include any additional assessment or charge in the nature of a premium which may be assessed or charged during the life of a contract of insurance, whether payable in one sum or in installments and however paid (and though never paid if the contract of insurance be delivered and accepted or otherwise becomes binding upon the insurer); (h) "premium" means the agreed price for assuming and carrying the risk. It includes all that is received by the underwriter therefor and is in fact the total consideration receivable for underwriting the risk, whether in one sum or in installments, during the life of the policy; (i) "United States" includes the States of the United States, the Territories of Alaska and Hawaii, and the District of Columbia.[239]

EFFECTIVE DATE. Policies of insurance which are issued and accepted on and after April 1, 1919, regardless of when the insurance thereunder becomes effective, are subject to tax; but policies which were issued and accepted prior to April 1, 1919, if issued in the usual course of business and according to general custom and not for the purpose of evading the tax, are not subject to tax.[240]

PERSONS LIABLE TO TAX. The insurer, the agent, or broker, effecting, accepting, placing or soliciting the insurance, and also the insured are each liable for the tax.[241]

WHAT INSTRUMENTS MUST BEAR A STAMP. The stamp must be affixed to the first instrument by which the insurance is made or renewed, i. e., by which the relationship of insurer and insured is created or evidenced, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called. In the case of so-called "open policies" or "open cargo covers," where the amount of the premium is not definitely determined at time of issuance, the stamps may be affixed to the receipts for monthly or other payments if proper notation be made upon such receipts identifying the original instruments to which they apply. In the case of a binder or other instrument whereby insurance is made or renewed, issued without agreement as to

239 T. D. 2891.
240 T. D. 2891. See Reg. 55, Art. 156.
241 T. D. 2891.

the premium to be charged, stamps must be affixed when the amount of the premium is determined.[242]

INSURED TO RETAIN POLICY FOR TWO YEARS. The person having control or possession of a policy of insurance or other instrument to which documentary stamps shall be affixed according to law shall retain such instrument for the period of two years from the date of issuance thereof, for the purpose of enabling internal revenue officers to verify the fact that payment of the full amount of tax due thereon has been made.[243]

SUBSEQUENT INSTRUMENT SHALL INDICATE PRIOR DOCUMENT TO WHICH STAMPS ARE AFFIXED. Any policy of insurance or other instrument which is subsequent to or which confirms a contract of insurance that is created or evidenced by any prior instrument by which insurance was originally made or renewed, should bear a notation designating such prior instrument (hereinafter referred to as the original instrument) and showing that the proper stamps have been affixed thereto and cancelled. By this is meant that, if a letter, cablegram, or other instrument is so worded that it establishes or evidences a contractual relation between the insurer and the insured, executed or executory, by which insurance is made or renewed, or by which the relationship of insurer and insured is created or evidenced, such instrument shall be construed as the original instrument, and must have stamps of the proper amount affixed to it, and any policy or other instrument which is subsequent to or which confirms such original instrument must bear thereon the notation above indicated.[244]

SUBSEQUENT INSTRUMENTS THAT MUST BE STAMPED. In case an instrument subsequent to the original instrument provides for the payment of a premium greater than the premium provided for in the original instrument, such subsequent instrument must have affixed thereto stamps equal to the tax imposed upon the additional premium charged therein; also such subsequent instrument must bear notation of the stamps affixed to the original instrument. The same rules apply to any riders, endorsements, or other forms attached to or forming a part of any

[242] T. D. 2891.
[243] T. D. 2891.
[244] T. D. 2891.

original or subsequent instrument where such rider, endorsement, or other form provides for the payment of a premium greater than theretofore charged.[245]

Unstamped Instruments and Those Bearing No Notation of Stamping. Failure (a) to stamp the original instrument by which insurance is made or renewed, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called, or (b) to indicate that such original instrument was properly stamped on any policy or other instrument which is subsequent to or which confirms the contract of insurance that is created or evidenced by any prior instrument by which insurance was made or renewed, will be held to raise a presumption of an intent to evade the payment of tax.[246]

Measure of Tax. The tax is measured by total premium paid, including any additional assessment or charge in the nature of a premium on each policy of insurance or other instrument by which insurance is made or renewed, and is at the rate of 3 cents on each dollar or fractional part thereof of such premium; for example, upon a premium charge of $10.10 the tax imposed is 33 cents, being 3 cents for each dollar and 3 cents for the fractional part of a dollar.[247]

Insurance on Commodities Exported. No tax is imposed upon the premiums charged for insurance issued to cover commodities which are in the actual process of exportation and which have begun their voyage or preparation for the voyage from the United States. If a policy or other instrument is issued covering both export and non-export property, the tax will be computed upon the full amount of the premium charged, unless such instrument clearly indicates the property for export and the premium charged for the insurance thereon.[248]

Movable Property. Movable property such as rolling stock of railroads, ships, vessels, barges, and other similar movable property, is held to be property within the United States if the principal place of business of the corporation or partnership, owning and controlling the same, is located within the United States, or in the case of an individual, if he resides in the United States, unless such

[245] T. D. 2891.
[246] T. D. 2891.
[247] T. D. 2891.
[248] T. D. 2891.

property is permanently located without the United States for the purpose of ordinary use. The nation of registry of a vessel has no bearing upon the location of the property in the same.[249]

CREDITS AND REFUNDS. In case a policy of insurance or other instrument is issued and accepted by the insured, and afterwards, for any reason, such insurance does not become effective, the value of the stamps affixed thereto will be refunded upon a proper claim presented to the collector.[250]

RETURNS. No monthly return or monthly statement showing a list of policies or other instruments by which insurance was made or renewed upon property located in the United States by a foreign corporation or partnership or non-resident individual is now required from any person to or for whom or in whose name such policy or other instrument is issued, or from the solicitor or broker acting directly or indirectly for or on behalf of such person, but each person, solicitor, or broker accepting, placing, or soliciting such policy or other instrument is required to keep a record of each policy or other instrument subject to the tax imposed by this subdivision by which he has directly or indirectly made, placed, solicited, or assisted in the making or renewal of, such insurance, or for which he has paid or received compensation, and shall be prepared to furnish full information to the Commissioner at any time upon demand.[251]

Leases. Leases are not taxed under this law.[252]

Mortgages. Mortgages are not taxed under this law.

Mutual Ditch and Irrigating Companies. Stocks and bonds issued by mutual ditch or irrigating companies are not taxable.[253] The law seems to exempt stock of such companies from the tax on the issue theerof,[254] and also from the tax on sale or transfers. The exemption does not extend to notes or any other instruments except certificates of stock and bonds.

Parcel-Post Packages. The tax is imposed upon every parcel or package transported from one point in the United States to another by parcel post on which the postage amounts to 25 cents

[249] T. D. 2891.
[250] T. D. 2891.
[251] T. D. 2891.
[252] Reg. 55, Art. 100.
[253] Revenue Act of 1918, § 1101.
[254] See Reg. 40 Rev., Art. 5.

or more. The tax is at the rate of 1 cent for each 25 cents of postage or fractional part thereof. The law requires the tax to be paid by the consignor. It is to be noted that the tax is only on parcels and packages transported from one point to another in the United States. Packages transported to foreign countries are not taxable.[255] Parcel-post shipments made by Federal reserve banks are exempt from taxation. Parcel-post packages mailed to or from Hawaii and Alaska are taxable. Parcel-post packages mailed to or from Porto Rico, Philippine Islands, Canal Zone, and the Virgin Islands are not taxable. Parcel-post packages mailed from one point in Porto Rico to another point in the same island are not taxable. Parcel-post packages mailed to United States naval vessels in foreign waters or to United States Expeditionary Forces abroad are not taxable.[256]

PACKAGES SENT BY A STATE OR POLITICAL SUBDIVISION THEREOF. Parcel-post packages sent by a State, or political subdivision thereof, in the exercise of its governmental functions, are not subject to tax. To relieve a package from the payment of the tax, the postmaster at the point of mailing should, however, require satisfactory evidence that it is sent by an officer or employee of a State or subdivision of the State, in the discharge of such functions.[257]

Passage Tickets. The tax on passenger tickets is only imposed on tickets sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada or Mexico. Such tickets are required to be stamped whether they are one-way or round-trip. No tax is imposed on tickets costing $10 or less. The rate is one dollar if the cost of the ticket does not exceed $30; $3 if the cost of the ticket exceeds $30 and does not exceed $60, and $5 if the cost of the ticket exceeds $60.[258] Where a single ticket is issued for transportation for more than one passenger the ticket, coupon or prepaid order must be stamped at the proper rate for each passenger based on the number of passengers, and the total amount paid for the transportation.[259] It is the duty of the person selling the ticket to affix the stamp to the ticket or paper which evidences the sale and cancel the stamp.[260]

255 Revenue Act of 1918, Title XI, A-14; T. D. 2599.
256 Reg. 55, Arts. 150—154.
257 Reg. 55, Art. 155.
258 Revenue Act of 1918, Title XI, Schedule A-10.
259 T. D. 2067.
260 T. D. 2067.

TICKETS SUBJECT TO TAX. Passage tickets issued to private individuals travelling on vessels operated privately or by any Government are taxable.[261] Passage tickets to Porto Rico or the Philippine Islands are taxable.[262] Passage tickets issued in the United States to ports not in the United States, Canada or Mexico on exchange orders purchased in Canada or Mexico in connection with through transportation from points in Canada or Mexico are subject to tax.[263] Passage tickets issued in the United States to ports not within the United States, Canada or Mexico on exchange orders purchased other than in the United States, Canada or Mexico, are subject to tax.[264]

TICKETS NOT SUBJECT TO TAX. Prepaid orders for passage tickets are not subject to tax.[265] Passage tickets issued to Hawaii or Alaska are not taxable.[266] Passage tickets sold in the United States from ports not within the United States, Canada or Mexico, to a port in the United States, Canada or Mexico, are not subject to tax unless sold as a part of a round trip or through ticket from a port in the United States, Canada or Mexico.[267]

PASSAGE TICKETS ISSUED TO FEDERAL AND STATE OFFICIALS AND FOREIGN REPRESENTATIVES. Passage tickets issued to United States Government officials, employees, military and naval forces, as well as officials of States and their political subdivisions, traveling in the course of their duty as such on vessels operated by private parties or by any government are not taxable when the amount of the passage is paid for by the United States Government, State or political subdivision thereof. Ambassadors, ministers, and properly accredited diplomatic representatives of any foreign government to the United States are exempt from the payment of taxes on such passage tickets. All other foreign agencies not specifically mentioned above are subject to the tax.[268]

Playing Cards. A tax of 8 cents per pack is imposed upon every pack of playing cards containing not more than fifty-four

[261] Reg. 55, Art. 114.
[262] Reg. 55, Art. 115.
[263] Reg. 55, Art. 118.
[264] Reg. 55, Art. 119.
[265] Reg. 55, Art. 117.
[266] Reg. 55, Art. 116.
[267] Reg. 55, Art. 120.
[268] Reg. 55, Art. 113; Vol. 2, Treas. Dec. (1898), No. 20196.

cards, manufactured or imported, and sold or removed for consumption or sale. This rate became effective on April 1, 1919.[269] It has been held that the statute imposing a tax on playing cards requires that each pack of cards shall show a stamp denoting a payment of the tax, and a dealer, therefore, may not reassemble the cards from packs on which the stamp tax has been paid and then offer the reassembled packs for sale in new wrappings without restamping.[270] Every manufacturer or importer of playing cards will be required to render a monthly report, under oath, on Form 749, in duplicate, showing the number of cards on hand at the first of the month, the number manufactured or received, likewise the number withdrawn, tax paid, or free of tax for export or use of the United States, and the number on hand at the end of the month, together with like information relative to the value of stamps received and used during the month. The report should be rendered on the last day of the month, or on or before the 10th day of the succeeding month. Blank returns, Form 749, may be procured from collectors.[271]

Powers of Attorney. Powers of attorney are taxable instruments under this law if they are such that they grant authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee. The tax attaches to or is imposed on the instrument itself and is not measured by the number of persons joining therein.[272] A power of attorney containing a power of substitution requires only one stamp.[273] Where the original power of attorney has been properly stamped and a copy of it has been printed on a card (Form 272) provided by the Government, and the card is filed in the executive departments of the Government or with a collector, such copy is not subject to tax.[274] The rate of tax on powers of attorney is 25 cents. The law expressly provides that no stamps shall be required on any papers

269 Revenue Act of 1918, Title XI, Schedule A-13. The Act of August 28, 1894, imposed a tax of 2 cents per pack on playing cards. The Act of October 3, 1917, imposed an additional tax of 5 cents per pack, or a total of 7 cents on each pack. The present law amends the former laws and provides a tax of 8 cents per pack as indicated in the text above. (T. D. 2817.)

270 U. S. v. Neustaedter, 149 Fed. 1010; Reg. 55, Art. 149.

271 T. D. 2817.

272 Revenue Act of 1918, Title XI, Schedule A-12. Reg. 55, Art. 130.

273 T. D. 2134.

274 Reg. 55, Art. 145.

necessary to be used for the collection of claims from the United States or from any State for pensions, back pay, bounty or for property lost in the miiltary and naval service.[275]. Powers of attorney required in bankruptcy cases are also expressly exempted.[276] The powers of attorney enumerated in the paragraphs immediately following are also exempt.

WARRANT OF ATTORNEY IN A LEASE. A warrant of attorney, embodied in a lease is not taxable.[277]

AUTHORIZING FEDERAL OFFICIAL TO SELL UNITED STATES BONDS IN CASE OF DEFAULT. Powers of attorney given by persons who deposit United States Liberty bonds or other bonds of the United States as security in lieu of surety or sureties on penal bonds under the provisions of Section 1320 of the Revenue Act of 1918, authorizing the official having authority to approve such penal bonds to collect or sell such United States bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bonds, are not subject to the stamp tax.[278]

AUTHORIZING OFFICER OF FEDERAL RESERVE BANK TO ASSIGN UNITED STATES BONDS DEPOSITED AS SECURITY. A power of attorney executed by a bank authorizing a designated officer of a Federal Reserve Bank to assign United States bonds deposited with the Federal Reserve Bank and designed to protect it in event of default in payment of a loan is not taxable.[279]

AUTHORIZING DEPUTY TO HAVE ACCESS TO SAFE. A power of attorney authorizing a deputy to have access only to safe or safety deposit box is not subject to tax, but a power of attorney to have access and control over its contents is subject to tax.[280]

EXECUTED OR ACCEPTED IN FOREIGN COUNTRY. A power of attorney executed by a person residing in a foreign country to a person in this country is taxable, as the instrument is not operative and

275 Revenue Act of 1918, Title XI, Schedule A-12.

276 This express exemption seems to have been introduced in the 1917 Law as a result of the decisions in the cases of In re Hawley, 220 Fed. 372, which held that a general letter of attorney in bankruptcy was taxable under the 1914 Law, and In re Capitol Trading Company, 229 Fed. 806, which held bankruptcy powers of attorney taxable under the 1914 Law.

277 Reg. 55, Art. 141.

278 T. D. 2913.

279 Reg. 55, Art. 147.

280 Reg. 55, Art. 146.

effective until delivered to the person to whom the power is granted; and, for the same reason, a power of attorney executed by a person residing in this country to a person in a foreign country is not taxable.[281]

FORMAL POWERS OF ATTORNEY. Powers of attorney which are merely formal and grant no authority which is not otherwise vested in the grantee are not taxable. Thus, it has been held that no tax is imposed upon powers of attorney in the following cases:

CONTAINED IN ASSIGNMENTS, FOR VALUABLE CONSIDERATION, CONFERRING NO AUTHORITY UPON ASSIGNEE NOT IMPLIED BY THE ASSIGNMENT, NOT TAXABLE. An assignment, for a valuable consideration, of debts, wages, mortgages, bonds, etc., ordinarily transfers to the assignee all the rights of the assignor and the remedies necessary for their enforcement, and the assignee acquires no further rights by the means of a power of attorney clause in the assignment than are conveyed by the instrument itself, and such pro forma power of attorney is therefore not taxable.[282]

ASSIGNMENT OF INSURANCE POLICIES. No stamp tax is imposed upon the power of attorney contained in a transfer by assignment, absolute or as collateral security, of an interest in a contract of insurance, if the power of attorney grants authority to do or perform only such acts for or in behalf of the assignor as are otherwise vested in the assignee.[283]

TO PAY POLL TAXES. Powers of attorney issued in accordance with the provisions of State statutes authorizing a person to pay a poll tax of an individual are not required to be stamped.[284]

POWER OF SALE. The power of sale generally embodied in a mortgage, real or chattel, authorizing and empowering the mortgagee himself upon default to make a public sale of the property affected and to convey the title to the purchaser at such sale, free from all rights or equity of redemption, thus avoiding the necessity of resorting to the courts for foreclosure, differs from a power of attorney in many respects, one of which is that the latter always creates an agency or a representative relation, whereas a mortgagee under a power of sale acts on his own behalf and for his

281 Reg. 55, Art. 142; T. D. 2134.
282 Reg. 55, Art. 137.
283 Reg. 55, Art. 134; T. D. 2599.
284 T. D. 2269.

own benefit. Such power of sale is not taxable as a power of attorney.[285]

PRO FORMA POWER OF ATTORNEY TO TRANSFER BONDS OR STOCKS ON BOOKS OF CORPORATION, PRINTED ON BOND OR STOCK CERTIFICATE. The pro forma power of attorney to transfer bonds or stocks on the books of a corporation, embodied in the assignment printed on the back of the bond or stock certificate, is not subject to tax.[286]

AUTHORIZING VENDEE OF SHARES OF STOCK TO TRANSFER SAME. A power of attorney by which a person executing the instrument sells, assigns, and transfers shares of stock and appoints the vendee agent for the transfer is not subject to the tax.[287]

GRANTED BY CORPORATION. Where a corporation by resolution of its Board of Directors has empowered an officer thereof to sell, assign or transfer stock or bonds standing in the name of the corporation, or to perform any act in the name of the corporation, such authority is not taxable as a power of attorney for the reason that it is necessary for a corporation to perform its corporate acts through one of its officers. If, however, a person other than an officer of the corporation acting in his official capacity is given this authority, the power of attorney so granted is taxable.[288] A general power of attorney granted by a Board of Directors to a person other than an officer of a corporation acting in his official capacity for the purpose of representing the corporation in transactions of a like kind and nature, such as conveying land or acknowledging deeds, is considered by the Treasury Department as specific authority for each individual transaction, and a revenue stamp is required on each instrument executed under the power of attorney.[289]

JUDGMENT NOTES. Where judgment notes contain a clause authorizing any attorney of law to confess judgment in favor of the holder of the note, such authorization is held not taxable as a power of attorney. The instrument is held to be a warrant of attorney instead of a power of attorney.[290]

285 Reg. 55, Art. 33; T. D. 2196.
286 Reg. 55, Art. 139; T. D. 2085; T. D. 2134.
287 Reg. 55, Art. 144.
288 Reg. 55, Art. 131.
289 Reg. 55, Art. 132.
290 Treat v. Tolman, 113 Fed. 892; Reg. 55, Art. 140; T. D. 2081.

From Corporations to Resident Agents. Powers of attorney executed by corporations to resident agents authorizing the latter to accept service of process are taxable.[291]

To Sell or Transfer Government Bonds. A power of attorney to sell or transfer Government Bonds is taxable.[292]

To Sell, Etc., Shares of Capital Stock. A power of attorney to sell, assign and transfer shares of capital stock is subject to tax unless it is given in connection with a deposit of the stock as security for a loan.[293]

When Tax Accrues. The Tax on a power of attorney is due when the instrument is executed and delivered, and not when the power is exercised.[294] Delivery includes depositing the instrument in the mails. Powers of attorney executed and delivered prior to April 1, 1919 are not taxable even though used subsequent to that date, except such as are taxable under the 1917 Law.[295]

Produce, Sales of, on Exchange. The tax is imposed upon (a) sales of, (b) agreements of sale, and (c) agreements to sell[296] for future delivery[297] any product or merchandise at or under the rules or usages of[298] any Exchange or Board of Trade, or other similar place.[299] In a case arising under the 1914 Law it was held that offers to sell grain made subject to deferred acceptance, only a small percentage of which developed into sales and on which the brokers received only $10 for each ten thousand bushels sold, were taxable on the basis of the total price on which the seller agreed to sell rather than the basis of what

291 Reg. 55, Art. 135.

292 Reg. 55, Art. 136.

293 Reg. 55, Art. 143.

294 Reg. 55, Art. 129; T. D. 2134.

295 Reg. 55, Art. 148.

296 See Treat v. White, 181 U. S. 264, and note 62. The term "sale" or "contract of sale" includes all sales, or agreements of sale, or agreements to sell, including so-called transfers or "scratch sales"; the term "agreement of sale," or "agreement to sell," includes options, calls in "puts and calls," offers, indemnities, and privileges. (Reg. 40 Rev., Art. 33.)

297 The Act of October 22, 1914, provided for a tax on agreements either for present or future delivery but made an express exemption to cover cases where products or merchandise were actually delivered at the time of sale or were in vessel, boat or car and actually in the course of transportation.

298 The words "or under the rules or usages of" were added by the Revenue Act of 1918, Title XI. Schedule A-5.

299 Revenue Act of 1918, Title XI, Schedule A-5; Reg. 40 Rev., Art. 22.

the buyer was to receive; and also that the tax was imposed on each sale or agreement to sell any grain, though during the day several distinct and separate sales were made of the same grain and at the close of the day the only memoranda made showed a transfer from the original seller to the last buyer.[300] So-called transferred or scratch-sales are no longer taxed, being expressly stated not to be included.[301] Neither are pass-outs subject to the tax.[302] No bill, memorandum, agreement or other evidence of a sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are subject to this tax. When the seller of commodities subject to this tax has paid the tax, he may transfer his contracts to a clearing house without paying a tax on such transfer if the transfer does not vest any beneficial interest in such clearing house association, but is made for the sole purpose of enabling the clearing house association to adjust and balance the accounts of its members on their several contracts. The rate is as follows: 2 cents for each $100 or fraction thereof in value of the merchandise covered by the sale or agreement of sale or agreement to sell.[303]

WHEN TAX ACCRUES. The stamp tax on sales of products and merchandise for future delivery accrues immediately upon the making of the sale, agreement of sale, or agreement to sell, and is in no wise dependent upon the manner of delivery of the product.[304]

300 Calkins v. Smietanka, 240 Fed. 138.

301 Reg. 40 Rev., Art. 23. So-called transferred or scratch sales were expressly included in the 1917 Law (Act of October 3, 1917, § 807, Schedule A-5). They were not mentioned expressly in the 1914 Law. The term "transferred or scratch sale" includes "pass-outs" or those transactions in which a person buys from another a certain quantity of any product, at a certain price, and at the same session of an exchange, sells to a third person the same quantity of the same product at the same price, and eliminates himself by instructing the person from whom he bought to deliver such product to the person to whom he sold; but no transaction in which a broker or a commission member of an exchange receives a commission greater than that charged to a person who executes his own contracts shall be deemed to be a "transfer" or a "scratch sale." (Reg. 40 Rev., Art. 33.)

302 Reg. 40 Rev., Art. 23.

303 Revenue Act of 1918, Title XI, Schedule A-5; Reg. 40 Rev., Art. 21.

304 Reg. 40 Rev., Art. 20.

IMMEDIATE OR PROMPT DELIVERY. Cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are not taxable.[305] "Immediate or prompt delivery" is held to mean delivery at once or as soon as practicable, and in any event within twenty days from the date of sale or agreement of sale or agreement to sell.[306] Every sale or agreement not evidenced by a memorandum or contract expressly requiring immediate or prompt delivery within the above definition is deemed to be for future delivery. In all cases in which the Commissioner is not satisfied from the evidence submitted to him that the transaction was in good faith intended to be followed by immediate or prompt delivery, within the above definition, the seller will be required to pay the tax as on a sale for future delivery.[307]

EXCHANGE OR BOARD OF TRADE. The law taxes only sales at or under the rules or usages of an exchange or board of trade or other similar place.[308] The term "exchange," except where it is plain from the context that a different meaning is intended, includes each and every agency, board of trade, bourse, auction place, or other meeting place, whether under shelter or in the open, at which products or merchandise are publicly bought, sold, bid for, offered, or exchanged, for future delivery, or contracts for such future delivery are made, either between members of such exchange, or between members and non-members, patrons, and the public; and includes places at which there is only one manager or firm, who controls all the sales and purchases at that particular place or where no actual delivery of the products or merchandise is contemplated, and all incorporated and unincorporated associations of individuals, partnerships, and corporations engaged in the business of publicly selling, buying, or exchanging products or merchandise for future delivery.[309]

305 Revenue Act of 1918, Title XI, Schedule A-5; Reg. 40 Rev., Art. 22.

306 Reg. 40 Rev., Art. 33.

307 Reg. 40 Rev., Art. 22; Reg. No. 40, Part II, Art. 4.

308 Revenue Act of 1918, Title XI, Schedule A-5.

309 Reg. 40 Rev., Art. 33. Reg. No. 40, Part 2, Art. 1. For a detailed consideration of the nature of an exchange or board of trade, see the case of Nicol v. Ames, 173 U. S. 509. This case went so far as to hold the Union Stock Yards to be a "similar place" within the meaning of the 1898 Law.

TRANSFERS TO CLEARING HOUSE. Sellers of products, merchandise or commodities having paid the tax provided by law may transfer such contracts to a clearing house association, and such transfer is not taxable within the provisions of the Act, provided that the transfer does not vest any beneficial interest in the clearing house association and is made for the sole purpose of enabling such clearing house association to adjust and balance the accounts of its members on their several contracts.[310] A clearing house is defined to be any incorporated or unincorporated association or committee carried on for the purpose of clearing, settling and adjusting transactions in purchasing, selling or delivering products or merchandise, whether such clearing house be a part or department of an exchange or an independent body.[311]

No sales or purchases of stock were made by members of the Union Stock Yards Company as such. Anyone was accorded the right to bring his cattle to the stock yards upon payment of the regular fees and compliance with the regulations made by the company, and, having brought his cattle, he had the right accorded him by the company to have them kept, fed, watered, etc., and to sell them himself or by a commission merchant, who did not need to be a member of the Stock Yards Company. The court said: "It is plain to be seen that the privilege or facility for a sale of the cattle or other stock at the yards of such company is of precisely the same nature and character as that which exists at an exchange or board of trade which is so described in terms. That the sales are made by the owners of the cattle or by commission merchants who are not members of the stock-yards company, is not material. The facilities for a sale exist and are made use of in each case, and are in truth the same in each. A perusal of the facts contained in the record in the case shows that those yards answer all the purposes of an exchange or board of trade, and that they in truth amount in substance to the same thing. The differences existing between them are unsubstantial so far as this point is concerned. The sales at that place are accomplished with a facility which it is plain could not exist but for the conditions and advantages afforded by the use of those yards. The owner of the cattle who brings them to the yards and avails himself of the privilege of selling them at that place does without doubt make use of a privilege which everyone knows is an advantage sufficient to constitute a material difference between a sale at the yards and a sale elsewhere. This advantage, although one which any person could use, is yet of precisely the same nature as that existing in the case of an exchange or board of trade, and it is therefore a similar place within the meaning of the statute. Being a similar place, the reasons stated in the foregoing cases apply with equal force here and demand the same judgment."

310 Revenue Act of 1918, Title XI, Schedule A-5; Reg. 40 Rev., Art. 23.

311 Reg. 40 Rev., Art. 33; Reg. No. 40, Part II, Arts. 1—4.

Inconsistent By-Laws, Rules, or Customs of Exchange. No provisions, by-laws, rules, or customs of any exchange, board of trade, or similar institution or place of business which are inconsistent or in conflict with any requirement or provision of the Revenue Act of 1918, or any regulations made thereunder, nor any collateral, or additional agreement, verbal or written, respecting the subject matter of such contract or the settlement or fulfillment thereof which is inconsistent or in conflict with any requirement of said act or regulations, will exempt any person from the payment of tax on sales of produce on an exchange.[312]

Sale of Stamps. The ruling of the Treasury Department in regard to the sale of stamps to be attached to sales, agreements of sale, or agreements to sell products or merchandise is given elsewhere in this book.[313]

Registration and Records. All persons engaged in the business of making contracts of sale on any exchange and all clearing houses and members of exchanges are required to register and keep records of transactions subject to the tax. The rulings in this respect are referred to more fully in a subsequent part of this chapter.[314]

Promissory Notes. The law provides that the tax on promissory notes, and for each renewal of the same, for a sum not exceeding $100 shall be 2 cents; and for each additional $100 or fractional part thereof 2 cents. Drafts or checks expressly payable otherwise than at sight or on demand are also taxable at the same rate.[315]

Who Affixes Stamp. The person who makes or issues a promissory note is required by the law to place the stamp upon the same and cancel it. If he does not do so the holder or owner may affix and cancel the stamp as agent for the maker. The drawee, payee or endorsee should see that the tax is paid before or at the time of acceptance or delivery. The question of who shall pay for the stamp is a matter of adjustment between the parties.[316] If a draft is presented to the drawee for acceptance and discount by him, stamps must first be affixed by the drawer, for the accep-

312 Reg. 40, Art. 24.
313 See p. 815.
314 See p. 808.
315 Revenue Act of 1918, Title XI, Schedule A-6; Reg. 55, Art. 63.
316 Reg. 55, Art. 35.

tance and delivery are simultaneous. The payee or the indorsee from the drawer must see to it that the drawer, as the person "who makes, signs or issues" the draft, pays the tax before delivery. "Accept" is used in the penal provision in Section 1102 in the general sense of "receive," not in the special sense peculiar to drafts. No drawee accepting an unstamped, undelivered draft would violate the law; but if the draft has already become taxable because of a prior delivery, the acceptor must be sure that stamps are affixed.[317]

Renewal of Notes. A renewal after the incidence of the tax of a note issued prior thereto is subject to tax.[318] Any writing or instrument however designated which operates as a renewal of a promissory note is taxable.[319] A written agreement, either attached or unattached to a promissory note or in the form of an endorsement on the note, such as "renewed" or "extended" to a certain date, evidencing payment and acceptance of interest in advance to a time certain, subsequent to maturity, constitutes a renewal of the note and is subject to tax as such.[320] Mere suspension of payment or forbearance is not taxable.[321] Part payment of a note after it becomes due, or payment of accrued interest after maturity, the note being allowed to run and the holder neither losing nor postponing his right of action, is merely in the nature of a forbearance and is not taxable as a renewal.[322] A contract or agreement extending either a chattel or real estate mortgage is not taxable, but if such extension effects the renewal of promissory notes, either embodied in the mortgage or given in connection with the mortgage, the renewal of such notes is taxable.[323]

Transfer of Notes. No stamp is required upon the transfer by indorsement of promissory notes.

317 T. D. 2682.

318 Revenue Act of 1918, Title XI, Schedule A-6. Letter from Treasury Department dated December 11, 1917; W. T. S. 1918, ¶ 3679.

319 Reg. 55, Art. 51.

320 Reg. 55, Art. 60. The following endorsement will operate under this rule as a renewal: "19—. Received six months interest to ———, 19—, $———."

321 Reg. 55, Art. 57.

322 Reg. 55, Art. 59. Letter from Treasury Department dated June 14, 1918; W. T. S. 1918, ¶ 3742. See T. D. 2265.

323 Reg. 55, Art. 52; T. D. 2170.

Definition of Promissory Notes. A promissory note is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand or at a fixed or determinable future time, a sum certain in money to such other person or to order or to bearer, free from restrictions as to registration or transfer, and usually without coupons.[324] The term "promissory notes," as used in the statute includes those payable on demand.[325] Promissory notes given for security only are taxable.[326] Whether or not an instrument is taxable as a promissory note depends upon its form and not upon its use. Thus, a receipt given by a loan company for property received as security for a debt is not a promissory note; but, if in the receipt there is included a promise to pay a certain sum of money at a specified time, with interest, for value received, such a provision in the opinion of the Treasury Department is a valid promissory note, upon which the maker would be liable in a suit at law, and is taxable.[327] Policy loan and premium extension agreements which contain an unqualified promise to pay a specified sum of money at a certain date are subject to stamp tax as promissory notes. Where the sole remedy of payee in case of nonpayment of the premiums or loans is to reduce or cancel the rights of the insured, tax does not accrue.[328] In the case of contracts for the purchase of pianos, machinery, and other merchandise, there is sometimes included, among other conditions and provisions, an agreement to pay the vendor a stipulated sum of money at a certain time, with interest, for value received. If this agreement is in form and effect a good and valid promissory note, upon which the maker would be liable in a suit at law, such promissory note is taxable. If, however, the contract merely provides for the payment of the purchase price in installments and enumerates the dates upon which such payments are due, stating, as many of the contracts do, that in default of payment the vendor may take the property, such agreement is not a promissory note.[329] It is often difficult to make a distinction between promissory notes and bonds of indebtedness. Although in a broad sense many notes

324 Reg. 55, Art. 48.
325 Reg. 55, Art. 49.
326 Reg. 55, Art. 50.
327 T. D. 2170.
328 Reg. 55, Art. 61; T. D. 2599.
329 T. D. 2170.

are bonds and many bonds are notes, obviously Congress did not intend to tax the same instrument under two heads.[330] An instrument, not under seal, containing a simple promise to pay a sum of money at a specified time, such as is common in every-day commercial use, is a promissory note.[331] It has been held, however, that the fact that a promissory note is under seal does not make it taxable as a bond.[332] A short term instrument, although issued by a corporation under a trust indenture, may be regarded as a note if every instrument of such issue both (a) is payable to bearer and incapable of registration and (b) lacks interest coupons, and so requires presentation upon each payment of interest.[333] Thus, the fact that a note may be secured by a mortgage or issued under a deed of trust does not necessarily make it taxable as a bond. One distinction between bonds and promissory notes seems to be the time for which the note or bond is to run. Promises to pay within a comparatively short period of time, such as one year or two years, are usually held to be taxable as notes while promises to pay at the end of a longer period are considered more in the nature of bonds or certificates of indebtedness. Instruments in the form of coupons representing the interest on bonds, debentures, or certificates of indebtedness, or on instruments however termed, issued by any corporation, known generally as corporate securities, which are attached to a principal obligation and are substantially but repetitions of the promise to pay interest contained in the principal obligation, are not subject to tax. Instruments in the form of promissory notes, representing the interest upon promissory notes, not included in the above classification, and either separate from or prepared in a form and for the purpose of being separated from the principal note, are subject to tax as promissory notes.[334]

CHECKS OR DRAFTS PAYABLE OTHERWISE THAN AT SIGHT OR ON DEMAND. The liability of an instrument to stamp tax, as well as the amount of such tax, is determined by the form and face of the instrument, and cannot be affected by proof of facts

[330] T. D. 2713. See Paragraph on Bonds of Indebtedness.

[331] T. D. 2713. See Paragraph on Bonds Given in Penal Sum.

[332] T. D. 21815. (Act of June 13, 1898.)

[333] T. D. 2713.

[334] Reg. 55, Art. 58. T. D. 2101. Kenosha v. Lamson, 9 Wall. 477; Lexington v. Butler, 14 Wall. 282.

outside of the instrument itself.[335] Unless the statute expressly so provides, drafts, acceptances, overdrafts, and postdated checks are not taxable as promissory notes, even though they perform some of the functions of a promissory note. It is no doubt in view of the decision above quoted that drafts and checks payable otherwise than at sight or on demand are by the present law expressly included in the same category as promissory notes. The general rule is that a draft or check delivered within the United States is subject to the tax *if expressed* to be payable otherwise than at sight or on demand.[336] So-called trade acceptances are taxable in the same manner as ordinary time drafts.[337] Drafts directly against an actual shipment are taxable in the same manner as other domestic time drafts.[338] Drafts drawn at sight or on demand with a notation thereon to "hold for arrival of goods," or payable "on arrival of car," or words of like effect, are taxable as drafts drawn otherwise than at sight or on demand.[339] Any notation appearing on such drafts, or on a bill of lading or other papers accompanying same, including collection letter, which defers the time of payment, renders the draft taxable.[340] But a sight draft accompanied by instructions outside the instrument, as "Do not present until arrival of car" or some such memorandum, is not taxable.[341] And a sight draft accepted and paid by the collecting bank for the drawee, which holds it and charges interest until the drawee

335 U. S. v. Isham, 17 Wall. 495. Reg. 55, Art. 37. In Granby Co. v. Webster, 98 Fed. 604, decided under the 1898 Law, the court, following U. S. v. Isham (supra) explains the rule as follows: "Were it necessary to inquire into all the circumstances attending the execution of an order for the payment of money, before it can be ascertained whether it be liable to the stamp tax, endless delay would be occasioned. The purpose of the tax—the prompt relief of the treasury—would be defeated." Under the 1914 Law it was held that in view of the decision in U. S. v. Isham, drafts, acceptances, overdrafts, and post-dated checks were not taxable as promissory notes, even though they were used in such a way as to perform some of the functions of a promissory note. (T. D. 2170.)

336 Reg. 55, Art. 63; T. D. 2682.

337 Reg. 55, Art. 39.

338 Reg. 55, Art. 40.

339 Reg. 55, Art. 37.

340 Letter from Treasury Department dated February 20, 1918; W. T. S. 1919, ¶ 3698. T. D. 2682.

341 Reg. 55, Art. 37; T. D. 2682.

takes it up, is not taxable.[342] A draft might be drawn stating no time for payment, which would class it as a sight draft, and be accepted at ninety days, which would change its nature.[343] If negotiated or delivered before acceptance the holder would be obliged to stamp it on acceptance, in default of which both he and the acceptor would be liable for the statutory penalty.[344] For the purposes of the tax there is no difference in the treatment of ordinary bills of exchange, trade acceptances, and bankers' acceptances, as defined by the regulations of the Federal Reserve Board.[345] The general rule is that a taxable draft or check becomes subject to tax concurrently with its delivery or acceptance. In the case of a draft the rule means that the tax attaches, not when it is signed by the drawer, or presented to the drawee for acceptance, but when it is delivered to or accepted by the payee, if drawn to a third person, or negotiated by the drawer, if drawn to his order. If a draft was drawn before the passage of the Act, but not delivered, accepted, or negotiated until afterward, the tax is payable.[346]

Drafts Drawn Against Exports. In view of the constitutional prohibition against a restriction of, or any tax on, exports, drafts with bills of lading attached covering goods in the course of exportation or drafts drawn in this country directly covering exports to foreign countries and which constitute an inherent, *bona fide* and necessary part of the process of exportation are exempt from the stamp tax.[347] This exemption does not depend on whether or not the time which the draft has to run will expire before or after the ocean shipment. Time drafts drawn against the proceeds of a draft against exports are taxable. A time draft drawn on a domestic bank for the purpose of securing money to purchase goods to be exported is

342 T. D. 2682.
343 Reg. 55, Art. 38.
344 T. D. 2682.
345 T. D. 2682.
346 T. D. 2682.
347 Reg. 55, Art. 41; T. D. 2682; Letter from Treasury Department dated April 13, 1918, W. T. S. 1919, ¶ 3711. Letter from Treasury Department dated January 24, 1918, W. T. S. 1919, ¶ 3710. See U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003. See paragraph on the Constitutionality of Stamp Taxes, p. 822.

subject to tax regardless of the fact that a contract for the sale of the goods existed at the time the draft is drawn.[348] Time drafts drawn on domestic banks against export shipments delivered to the first carrier for transportation covering the period of transit from the interior point to the seaboard, are not subject to tax.[349] Time drafts not covering exports drawn and delivered or accepted in the United States and payable in foreign countries are taxable.[350] Stamp tax attaches to time drafts covering articles shipped from the United States, Hawaii, and Alaska to Canal Zone, if the drafts are delivered within the United States, Hawaii, or Alaska.[351] Stamp tax does not attach to time drafts covering shipments to the Virgin Islands, Philippines, and Porto Rico, because of express legislation exempting shipments to these dependencies.[352]

TIME DRAFTS COVERING SHIPMENTS FROM VIRGIN ISLANDS, PHILIPPINES, AND PORTO RICO. Time drafts drawn against shipments from the Virgin Islands, the Philippines, and Porto Rico, into the United States, are subject to stamp tax if delivery or acceptance of said drafts first takes place within the United States, Alaska, or Hawaii.[353]

DRAFTS DELIVERED IN FOREIGN COUNTRIES. The general rule is that a taxable draft or check becomes subject to the tax concurrently with its acceptance or delivery within the territorial jurisdiction of the United States (including the States, the District of Columbia, Hawaii, and Alaska), whichever is prior. The rule means that the tax does not attach to a draft drawn here, but delivered and accepted abroad, but does attach to a draft drawn abroad and delivered or accepted here.[354] In general, a draft sent through the mail is delivered when and where deposited in the mail addressed to the payee or the indorsee from the drawer.[355] If a draft drawn abroad, on a foreign drawee, with a foreign payee,

348 Reg. 55, Art. 42.

349 Reg. 55, Art. 43.

350 Reg. 55, Art. 44.

351 Reg. 55, Art. 45

352 Reg. 55, Art. 46

353 Reg. 55, Art. 47.

354 Telegram from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 3769.

355 Revenue Act of 1918, Title XI, Schedule A-6, contains the expression "upon their acceptance or delivery within the United States, whichever is

passes through a bank here in the course of collection, no tax is payable unless it should be delivered by an agent of the drawer to an agent of the payee within the United States.[356]

NOTES DRAWN IN FOREIGN COUNTRIES. A promissory note drawn in a foreign country, and placed in the mails in that country for delivery to a person residing in the United States, is not required to be stamped. Delivery of commercial paper is necessary for its completion and by the weight of authority such an instrument is delivered when placed in the mails. The laws of the foreign country, therefore, would determine the validity of the contract, even if the instrument is made payable in the United States. On the other hand, a promissory note drawn in the United States and placed in the mails for delivery to a person residing in a foreign country is taxable, for the reason above stated.[357]

NOTES SECURED BY PLEDGE OF UNITED STATES SECURITIES. No stamp tax is required or imposed upon a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations, provided, that in either case the par value of such bonds or obligations does not exceed the amount of such note.[358] The bonds mentioned include Liberty Bonds as well as other United States bonds and printed obligations.[359] The Treasury Department has ruled that promissory notes secured by certificates of indebtedness issued by the Director General of Railroads are exempt from stamp tax;[360] and that promissory notes secured by bonds of the War Finance Corporation are subject to tax.[361]

prior.'' The 1917 Law was silent in this respect. See Reg. 55, Arts. 33, 34, modifying T. D. 2682.

356 Reg. 55, Art. 36; T. D. 2682.

357 Reg. 55, Art. 64, 65; T. D. 2170. See also T. D. 2682.

358 Revenue Act of 1918, Title XI, Schedule A-6. This provision is now expressly included in the Stamp Tax Act, its substance having formerly been contained in T. D. 2701, based upon the War Finance Corporation Act, Title 3, 301.

359 T. D. 2701. War Finance Corporation Act, Title 3, 301; Revenue Act of 1918; Title XI, Schedule A-6.

360 Reg. 55, Art. 56; Letter from Treasury Department dated May 10, 1919; W. T. S. 1919, ¶ 3776.

361 This ruling seems contrary to the purpose of the statute. The exemp-

NOTES ISSUED BY GOVERNMENT. The law provides that no bond, note or other instrument issued by the United States or by any foreign government or by any state, territory, or the District of Columbia or local subdivision thereof, or municipal or other corporation exercising the taxing power, shall be subject to tax.[362] Bank notes issued for circulation are also expressly exempted from the tax.[363] Promissory notes accompanying mortgages of joint-stock land banks are taxable.[364] Promissory notes issued by the Food Administration Grain Corporation are subject to stamp tax.[365]

Proxies. The tax is imposed on every proxy for voting at any election of officers[366] or for voting at any meeting for the transaction of business of any corporation. The term "corporation" is defined to include associations, joint-stock companies and insurance companies.[367] Under the 1914 law the tax was only on proxies for voting at any election of officers. The present law, as well as the 1917 Law, taxes all proxies used at meetings for the transaction of business. The tax is 10 cents on each

tion referred to at beginning of the above paragraph was taken from the War Finance Corporation Act, as stated in note 358, and seems to have been intended to apply to War Finance Corporation bonds. In this connection the following definition of the term "obligation or other security of the United States" from R. S. 5414, referring to offences against the currency, etc. "The words 'obligation or other security of the United States' shall be held to mean all bonds, certificates of indebtedness, national-bank currency, coupons, United States notes, Treasury notes, gold certificates, silver certificates, fractional notes, certificates of deposit, bills, checks, or drafts for money, drawn by or upon authorized officers of the United States, stamps and other representatives of value, of whatever denomination, which have been or may be issued under any Act of Congress," is interesting and seems broad enough to include War Finance Corporation Bonds. There seems to be no valid distinction between certificates of indebtedness issued by the Director General of railroads and War Finance Corporation Bonds for purposes of this exemption.

362 Revenue Act of 1918, § 1101.

363 Revenue Act of 1918, Title XI, Schedule A-6.

364 Reg. 55, Art. 53.

365 Telegram from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 3768.

366 Directors of a corporation are officers within the meaning of the clause imposing a tax on proxies for voting at the election for officers of an incorporated company. (Reg. 55, Art. 123.)

367 Reg. 55, Arts. 126-127.

proxy. Proxies for voting at any election of officers, or meeting for the transaction of business of any religious, educational, charitable, fraternal, or literary societies, or public cemeteries, are expressly exempt.[368] Proxies for the purpose of voting the stock of building and loan associations are taxable.[369]

PROXIES SIGNED BY TWO OR MORE STOCKHOLDERS. The stamp tax on proxies attaches to the instrument and is not measured by the number of grantors and grantees.[370] A power of substitution contained in a proxy would seem not to be taxable either on the ground that it is a proxy or on the ground that it is a power of attorney.

WHEN TAX ACCRUES. It seems that the proxy need not be stamped until it is accepted by the person to whom it is issued, but must be stamped before it can be used. Thus, it has been held that a power of attorney or proxy executed by a person residing in a foreign country to a person residing in this country is taxable, as the instrument is not operative and effective until accepted by the person in this country to whom it is issued. Powers of attorney and proxies executed by a person residing in the United States to a person in a foreign country are not taxable.[371] Powers of attorney or proxies executed and accepted before the incidence of the tax are not taxable, even though used after the incidence of the tax.[372]

WHO MAY AFFIX STAMPS. Where proxies are sent out by corporations to be executed and returned to the corporation or to the person named in the proxy, such proxies may be stamped after execution and delivered by the person receiving the same as the agent of the person executing the proxy.[373] The stamp may be affixed and cancelled either by the party who executes the proxy or by the party to whom the proxy is given.[374] Where the stamp is affixed by an officer or employee of the corporation it is sufficient to cancel the stamp by writing thereon the initials of the officer or employee or the initials of the corporation and

368 Revenue Act of 1918, Title XI, Schedule A-11.
369 Reg. 55, Art. 124.
370 Reg. 55, Art. 121, modifying T. D. 2129.
371 T. D. 2129.
372 Reg. 55, Art. 125.
373 Reg. 55, Art. 128; T. D. 2067.
374 Reg. 55, Art. 122; T. D. 2129.

by incision or perforation if the stamp has a value of 10 cents or more.[375]

Rights to Receive Stock Dividends. Such rights are taxable as certificates of profits.[376] See Capital Stock, Sales and Transfers above.

Rights to Subscribe for Stock. Under the present law, rights to subscribe for stock or to receive shares or certificates of stock (or of profits or interest in property or accumulations) in any corporation are expressly made subject to tax.[377] See Capital Stock, Sales and Transfers, above.

Security Agreements and Applications for Loans. Neither a security agreement signed by a prospective borrower of a bank, empowering the bank to apply any securities, money, or other property of the prospective borrower in the hands of the bank to satisfy the debt of the borrower to the bank, nor the form of application for the loan, is included in the classes of instruments made subject to stamp tax under Schedule A of Section 1107, and neither is therefore subject to such tax.[378]

Voting Trust Certificates. The issue of voting trust certificates is not subject to the stamp tax[379] but the transfer of such certificates is subject to the tax.[380] See Capital Stock, Issue and Capital Stock; Sales and Transfers; above.

Records Required in Case of Sales and Transfers of Stock. Every person who makes an agreement to sell or transfer title to shares of stock by delivery of certificates assigned in blank, shall as a part of such transaction promptly make and deliver to the buyer a bill or memorandum of such sale or agreement to sell, duly signed by the seller or his agent, to which the requisite stamps shall be affixed and canceled, which bill or memorandum shall show the date of the transaction, the names of the seller and buyer and the name and number of shares of stock, and the price per share and the tax paid thereon, and in the case of a transaction made on an exchange shall bear a number upon the face thereof and have printed and written in ink thereon

375 Letter from Treasury Department dated January 8, 1915.

376 Reg. 40 Rev., Art. 12.

377 Revenue Act of 1918, Title XI, Schedule A-4; Reg. 40 Rev., Art. 12.

378 See T. D. 2599.

379 Reg. 40 Rev., Art. 5.

380 Reg. 40 Rev., Art. 12.

the words "Subject to the Revenue Act of 1918 and regulations made in accordance therewith." No more than one such bill or memorandum made by the seller on any given date shall bear the same number: Provided, however, that no single transaction or purchase or sale that is made upon an exchange by one member to another member shall require to be evidenced by more than one stamped memorandum of sale or agreement to sell.[381]

DEFINITIONS. The term "exchange" includes each and every agency, office, room, or other place of asesmbly whether under shelter or in the open, at which stock, rights, warrants, interests in property, or in profits, or in accumulations, by corporations, are publicly bought, sold, bid for, offered or exchanged between persons there assembled, in behalf of themselves or others. The term "clearing house" includes every corporation or association, whether incorporated or not, of individuals, partnerships or corporations wholly or partly engaged in the business of clearing, settling, or adjusting transactions in the purchase, sale, receipt, or delivery of shares of stock, whether or not the same be a part or department of an exchange or an independent body.[382]

RECORDS OF SALES OR TRANSFERS OF STOCK. (a) All persons who are wholly or partly engaged in the business of buying, selling or transferring shares of stock, whether at public or private sale, or whether or not they are members of an exchange, including persons engaged in transactions known as "matched," or "on-order," or "pass-outs," or "give-ups," or settled directly between the seller and buyer, or cleared or adjusted through a clearing house or otherwise, or engaged in accepting and pro-

381 Reg. 40 Rev., Art. 15; Reg. No. 40, Part I, Art. 6. In McClain v. Fleishman, 106 Fed. 880, a stock broker entered into agreement with his customers to buy and sell stocks on a fixed price for future delivery. Each of such agreements was evidenced by the written memoranda properly stamped in accordance with the 1898 Law. The transfers were purely speculative, conducted on margins and no actual delivery was contemplated by the parties, settlement being made by a payment of differences and the surrender of the written memoranda. It was held that such settlements did not involve agreements for a resale of the stocks requiring new memoranda to be made and stamped, the court having no authority to infer such agreements contrary to the fact for the purpose of extending statutory provisions to transactions not within its terms.

382 Reg. 40 Rev., Art. 33.

curing the transmission of orders for purchase or sale of shares of stock shall keep a record showing:

(1) Date of transaction.
(2) Line number (if at an exchange).
(3) Name of broker or salesman who executed the order.
(4) Name of party to whom sold, or from whom bought.
(5) Number of shares dealt in.
(6) Name or description of stock.
(7) Price of stock, if without face or par value.
(8) Amount (or total market value) of stock.
(9) Face or par value of stock per share.
(10) Tax paid on shares having face or par value.
(11) Tax paid on shares without face or par value.
(12) State tax paid, if any. (Optional.)
(13) Total amount to ledger. (Optional.)
(14) Folio number. (Optional.)
(15) Name of customer for whom sold or transferred, or for whom bought or transferred.
(16) Number of shares loaned or borrowed.
(17) Number of borrowed or loaned shares returned.
(18) Method of settlement or adjustment.

(b) Persons keeping such records may incorporate therein additional columns that will be of use to them, such columns to be placed so as not to interfere with the columns and headings hereby prescribed. These records must be in book form, and all entries therein must be legibly written in ink and the records kept for a period of at least two years. Such record forms will not be supplied by the department.

(c) The form of record required is known as Form A.

(d) Provided, however, that brokers known as strictly "floor brokers," or "two dollar men," or "room traders," in lieu of the foregoing record, whether their transactions are settled directly between seller and buyer or by "matched," "on-order," "pass-out," or "scratch sale," or "give-up," or any other kind of sale or purchase, or are cleared through a clearing house or otherwise, shall keep a record showing:

(1) The date of the transaction.
(2) The name of the seller.
(3) The name of the purchaser.
(4) The name of the stock.

(5) The number of shares.
(6) The par or face value of the shares.
(7) The price, if the stock has no par value.
(8) Whether the transaction is "matched," "on-order," "pass-out," "scratch sale," or "give-up."
(9) Name of person to whom "given-up."

(e) Provided further, that persons engaged in accepting and procuring the transmission of orders for the purchase or sale of shares of stock to be executed at a brokerage office or an exchange, board of trade, or similar place, shall keep a record showing:

(1) Date of acceptance and transmission of order.
(2) Name of person from whom accepted.
(3) Name and address of person to whom transmitted.
(4) Name of stock.
(5) Par value of stock.
(6) Number of shares.
(7) Whether purchase or sale.
(8) Price.
(9) Whether order was executed at an exchange; and, if so, what exchange.
(10) Date of execution of order.[383]

RETURNS BY PERSONS MAKING SALES. All persons who are wholly or partly engaged in the business of buying, selling, or transferring shares of stock, whether such sales, purchases, or transfers shall be made, cleared, settled or adjusted through a clearing house, or otherwise, shall on or before the fifteenth day of each month, and at any other time designated by the Commissioner, render under oath a true return of all such sales and purchases to said Commissioner for the preceding month or for any other period designated by the Commissioner, containing in detail the following data and information: (1) The month for which the return is made. (2) The name and address of the person, partnership, corporation, or association making the return. (3) The number of shares sold and purchased elsewhere than at an exchange. (4) The number of shares sold and purchased at an exchange and cleared by a clearing house. (5) The number of shares sold and purchased at an exchange and not cleared by a

[383] Reg. 40 Rev., Art. 16.

clearing house. (6) The number of shares having a par or face value. (7) The number of shares without par or face value whose actual value is less than $100 per share. (8) The number of shares without par or face value whose actual value is in excess of $100 per share. (9) The number of shares of stock loaned. (10) The number of shares of such loaned stock returned. (11) The number of shares of stock borrowed. (12) The number of shares of borrowed stock returned. (13) The amount of tax paid. (14) The amount of stamps on hand on the first day of the month, or other period. (15) The amount of stamps purchased during the month, or other period. (16) The amount of stamps on hand on the last day of the month for which return is being made. (b) Provided, that brokers known strictly as "floor brokers" or "two dollar men," or "traders," in lieu of the foregoing return shall render a return only as to such transactions as were not "given-up" to or cleared through some other broker, including direct settlements, "pass-outs," or "scratched sales;" (c) provided, further, that in the event any broker who has not closed business shall make no sales or purchases of stock during any one month he shall file with the Commissioner a statement to that effect in lieu of a return.[384]

Returns by Clearing Houses. (a) If any person, who negotiates sales or transfers of stock on a stock exchange, shall appoint in writing the clearing house for the exchange upon which such sales or transfers are made his agent for the purposes hereinafter indicated, and shall make to such clearing house a written return, statement, or sheet, on each business day, containing a full disclosure of all such transactions, both clearable and non-clearable, of the preceding day, in shares of stock that are listed or permitted to be dealt in by such member on such exchange, and also showing which, if any, of such stocks are loaned or borrowed or returned, then in that event such return, statement, or sheet, delivered to the clearing house, shall be deemed to be the bill or memorandum of sale or agreement to sell, required under subdivision 4, Schedule A, Revenue Act of 1918, and such clearing house is hereby authorized to affix to such return, statement, or sheet the amount of stamps required for each sale or agreement to sell or memorandum of sale or delivery or transfer of the stock

[384] Reg. 40 Rev., Art. 17.

indicated thereon, and to cancel the stamp so affixed. (b) The affixing and cancellation of such stamps by the clearing house shall be held to be the act of the person making such sale or agreement to sell, or memorandum of sale, or delivery or transfer of such stock; or if such person and clearing house so elect, such person shall affix and cancel such stamps before delivering such clearing house sheets or memoranda of sales to the clearing house, but such clearing house shall not accept such clearing house sheet or memoranda unless stamps for all transfer tax required to be affixed are attached thereto and properly canceled. (c) The returns, statements, or sheets made to the clearing house shall in respect of each sale show the date thereof, the name of the seller, the name of the buyer, the amount of the sale, and the name of the stock, or certificates, or other things traded in, but a return for more than one sale may be made upon the same return, statement or sheet; and no settlement of differences or other dealings between members shall be permitted that will interfere with the full disclosure of the whole transaction. (d) Said clearing house shall preserve the returns, statements, or sheets so made and stamped for at least two years. (e) Such return, statement, or sheet to the clearing house shall not relieve the seller from making and delivering to the buyer the bill or memorandum required by Article 15 of Regulations 40 (Revised). (f) When a clearing house carries upon its sheets or records information or reports of transactions showing the transfer by one of its members of an account of a customer without change of ownership of the securities of the customer, there shall be kept by the members of such clearing house or body concerned in such transaction a record showing the particulars of such transaction.[385]

Stock Transfer Stamps. (a) Ordinary documentary stamps with the words "Stock transfer" overprinted thereon, known as "Stock transfer stamps," shall be affixed to all sales or agreements to sell, or memoranda of sales, or deliveries of or transfers of legal title to shares or certificates of stock or of profits, or of interest in property or accumulations of a corporation, joint-stock company, or association, and all "warrants," rights, and other securities, made at exchanges or similar places. (b) Ordinary

[385] Reg. 40 Rev., Art. 18. For a definition of the term "clearing house" and "exchange" see Reg. 40 Rev., Art. 33. See p. 803.

documentary stamps may be affixed to sales, agreements to sell, or memoranda of sales not made at exchanges or similar places.[386]

Records and Returns Required in Case of Sales of Produce or Exchange: (a) Every person who makes sales, or agreements of sale, or agreements to sell, any products or merchandise at or under the rules or usages of any exchange, board of trade, or similar place, for future delivery, shall deliver to the buyer bill, memorandum, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp in value equal to the amount of the tax on such sale. (b) Such bill, memorandum, or other evidence duly stamped shall be kept by the buyer for two years, unless otherwise prescribed by regulation. (c) No single sale or agreement of sale, or agreement to sell, made upon an exchange by one member for another need be evidenced by more than one stamped bill, memorandum, or agreement.[387]

CLEARING HOUSE AS AGENT. (a) If any person who makes sales, agreements of sale, or agreements to sell any products or merchandise at or under the rules or usages of any exchange, board of trade, or similar place, for future delivery, shall in writing appoint the clearing house for the exchange upon which such sales are made, his agent for the purposes hereinafter named, such clearing house being approved by the Commissioner, and shall make a written return or sheet of each sale to such clearing house in accordance with the regulations, such return or sheet shall be deemed to be the bill, memorandum, or other evidence required by the regulations to be delivered by the seller to the buyer, and the clearing house is authorized to affix to such return or sheet the amount of the stamps required for each sale, agreement of sale, or agreement to sell as indicated thereon and to cancel the stamps so affixed. (b) The affixing and canceling of such stamps by the clearing house shall be held to be the act of the person making such contract of sale. (c) If the person making such sale and the clearing house so elect, the seller may affix the stamps to the clearing house return or sheet and cancel the same before or at the time of delivery to the clearing house. The clearing house shall in no

386 Reg. 40 Rev., Art. 19.
387 Reg. 45 Rev., Art. 25.

event accept such bill, memorandum of sále, or clearing house return or sheet unless stamps for all the tax required to be paid thereon are attached and properly canceled. (d) The returns or sheets of sales so made to the clearing house shall in respect of each sale, set forth the date, the name of the seller, the name of the purchaser, the amount of the sale, the matter or things to which it refers, and the tax paid thereon, but a return for more than one sale may be made on the same paper or sheet. (e) The clearing house shall preserve for a period of not less than two years, each bill, memorandum or return, or sheet made to it by such person. (f) Every clearing house shall include in its monthly return to the Commissioner a statement of the amount of stamps so affixed and canceled on the returns or sheets of each person. (g) The making of such return by the clearing house shall not relieve any person making such sale, or agreement of sale, or agreement to sell, from making the monthly return of his transactions required by the regulations.[388]

RECORDS TO BE KEPT BY BUYERS AND SELLERS. (a) All persons who make sales or agreements of sale of, or agreements to sell (including so-called "transferred or scratch" sales, "pass-outs," "pair-offs," "matched trades," or "give-ups") any products or merchandise at, or under the rules or usages of, any exchange for future delivery, or are engaged in the business of accepting and transmitting orders for the purchase of such products or merchandise to be executed at, or under the rules or usages of any exchange for future delivery, shall keep a record showing: (1) Date of contract. (2) Name of person executing contract (floor broker). (3) To whom sold or from whom bought (name and address). (4) Whether transaction is a purchase or sale. (5) Quantity of product or merchandise involved, whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or whatever other unit of weight or measure is used. (6) Name of product or merchandise, including (if not a basis grade) grade, type, sample, or description. (7) Whether contract is a "basis-grade," "deferred acceptance," or whatever kind of contract. (8) Price specified per ton, pound, bale, bushel, bag, mat, barrel, gallon, or whatever other unit of weight or measure is used. (9) Tax paid. (10) Customer (name and ad-

388 Reg. 40 Rev., Art. 26. See Reg. 40 Rev., Art. 29.

dress). (11) Origin of order (whether domestic or foreign). (12) Month or time specified in contract for delivery. (13) Date of settlement. (14) Method of settlement or adjustment. (b) Provided, that "floor brokers," or "two-dollar men," or "room traders," in lieu of the foregoing record, shall keep a record showing: (1) Date. of transaction. (2) Name of person who executed the order, if other than the floor broker. (3) Name of seller. (4) Name of buyer. (5) Quantity of product or merchandise involved in the transaction. (6) Name of product or merchandise, including (if not a basis-grade contract) grade, type, sample, or description. (7) Whether the contract is a basis-grade contract. (8) Price. (9) Time specified in contract for delivery. (10) Name of persons to whom "given up," "paired off," "transferred or scratched," or "passed out." (c) And other transaction than those specified in this proviso made by "floor brokers," "two-dollar men," or "room traders," shall be kept on the first form described in this paragraph. (d) Persons who use either of such forms may incorporate additional columns which may be of use to them, such columns to be so placed as not to interfere with the columns and headings herein prescribed. (e) Such record forms will not be supplied by the department. (f) The foregoing records shall be legibly written in ink, and contracts of sale for future delivery of two or more distinct products or merchandise shall be kept separate. Each person who executes or makes such contracts of sale shall preserve the books, bills, memoranda, "sales tickets," or trading cards of all transactions, and the purchaser shall preserve the bill, memorandum, agreement, or evidence of sale to which the stamps are affixed for the period of two years, that they may be readily inspected by the revenue officer. (g) The form of record required is known as Form B.[389]

Records to Be Kept by Clearing Houses. (a) All persons who act in the capacity of a clearing house shall keep a record showing: (1) Name of person for whom each contract is cleared. (2) Date when contract was made. (3) Whether the transaction is a purchase or sale. (4) Quantity of product, or merchandise, involved, whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or other unit of weight or measure,

389 Reg. 40 Rev., Art. 27.

as the case may be. (5) Name of product, or merchandise, including (if not a "basis-grade" contract) grade, type, sample, or description. (6) Whether the contract is a "basis-grade" contract. (7) Time specified in contract for delivery. (8) Date of settlement. (9) Method of actual settlement. (b) Records of sales for future delivery of two or more distinct products or merchandise must be kept separate. (c) The clearing house shall preserve such records for the term of two years. (d) Such record forms will not be supplied by the department.[390]

RETURNS OF TRANSACTIONS. (a) All persons who make contracts of sale or purchase of any product or merchandise, at or under the rules or usages of any exchange, board of trade, or other similar place of business, for future delivery, whether such contracts shall be cleared and adjusted through a clearing house, or directly between the seller and buyer, or otherwise, shall on or before the fifteenth day of each month, or at any other time required by the commissioner, make a return in writing to the commissioner, for the preceding month or any other period, verified before some officer authorized to administer oaths, showing (1) The number of contracts of sale and purchase of each product or merchandise brought forward from the preceding month or period. (2) The number of contracts of sale and purchase of each product or merchandise on each day during the current month or period. (3) The months in which the products or merchandise are to be delivered. (4) The method of settlement of each contract, i. e., whether by "actual delivery," "notice," "ring," "direct," "transfer," "scratch sale," "pass out," "matched," "pair off," "set-off," "give up," through a clearing house or otherwise. (5) The tax paid thereon. (6) The number of contracts both of purchase and sale carried forward at the end of the month or period. (7) The amount of stamps on hand at beginning of month or period. (8) The amount of stamps purchased during month or period. (9) The amount of stamps used during month or period. (10) Balance of stamps on hand at end of month or period. (11) The origin of the order or the contracts, whether domestic or foreign. (b) Provided, that "floor brokers," or "two-dollar men," or "room traders" may omit from their returns information called

390 Reg. 40 Rev., Art. 28.

for under paragraph marked (1), (6), and (11). But in the event such "floor brokers," "two-dollar men," or "room traders" shall make or settle transactions in any other way than by "transferred or scratch sales," "give ups," or "pass outs," they shall make the full returns prescribed in this paragraph. (c) Such returns shall be made upon forms to be furnished, upon application, by the collector of internal revenue, of the district in which the exchange, board of trade, or other similar place is located.[391]

RETURNS BY CLEARING HOUSES. (a) Every clearing house shall on or before the fifteenth day of each month, and at such other times as required by the Commissioner, make return in writing, under oath, to the Commissioner, for the preceding month or other period, showing: (1) The number of open contracts "long" and "short" brought forward for each member from the preceding month. (2) The number of contracts bought and sold by each member of the association. (3) The number of tons, pounds, bales, bushels, bags, mats, barrels, or gallons, or other units of weight or measure involved in such contracts, as the case may be. (4) The month in which such product, merchandise, or commodity is to be delivered. (5) The method of settlement of said contracts, i. e., whether by "set off," "notice," or "delivery," or by what method. (6) Total tax paid by each member of the exchange. (7) The number of open contracts "long" and "short" carried forward for each member to the following month. (b) Such returns shall be made upon forms to be furnished, upon application, by the collector of internal revenue of the district in which the clearing house is situated.[392]

STAMPS MAY BE AFFIXED TO RETURNS. (a) If any exchange shall by proper resolution request the Commissioner to permit the members of such exchange to affix the requisite amount of stamps on the returns made by such members to the Commissioner of all transactions made by such member at such exchange and cancel such stamps, and shall file with the Commissioner a copy of the charter and by-laws of such exchange accompanied with a list of the names and addresses of the officers and members of such ex-

391 Reg. 40 Rev., Art. 29.
392 Reg. 40 Rev., Art. 30.

change, designating those of such members who are active and those who are inactive on the exchange, then upon approval of such resolution by the Commissioner, instead of affixing the stamps to the bill or memorandum of sale as now required, it shall be lawful for the members of such exchange to affix the amount of stamps on such returns as shall represent the aggregate amount of tax due on all sales, agreements of sale, or agreements to sell, made by such member during the preceding month or other period designated by the Commissioner and such stamps shall be canceled by such member in the manner prescribed in the regulations. (b) Such returns, duly stamped, shall be filed and preserved for two years. (c) The stamping and filing of such returns shall not in any way relieve the members of such exchange from making and delivering to the buyer the memorandum or bill of sale prescribed by law and the regulations, nor the buyer from the necessity of preserving the same for the term of two years.[393]

FUTURE DELIVERY STAMPS. The stamps to be used on sales, agreements of sale, or agreements to sell products or merchandise at or under the rules or usages of any exchange, or board of trade, or other similar place, for future delivery shall be the ordinary documentary stamps with the words "Future delivery" overprinted thereon, and they shall be known as "Future delivery stamps."[394]

Registration of Brokers, etc. (a) Every person engaged, in whole or in part, in any of the following businesses or activities, shall file a statement for registration with the collector of internal revenue of the district in which his principal office or place of business is located: (1) Persons engaged in negotiating, making, or recording sales, agreements to sell, deliveries or transfers of shares or certificates of stock, or rights, or warrants, or certificates of beneficial interest in profits, property, or accumulations of a corporation. (2) Persons conducting or transacting a stock brokerage business. (3) Persons accepting or procuring the transmission of orders for the purchase or sale or transfer of stocks, rights, warrants, certificates of beneficial interest, or interests in property, profits, or dividends, to be executed at a stock brokerage office or an exchange or similar place. (4) Persons engaged in the business of transferring stock other than their own. (5) Persons engaged in

393 Reg. 40 Rev., Art. 31.
394 Reg. 40 Rev., Art. 32.

making sales or agreements of sale of, or agreements to sell, any products or merchandise at, or under the rules or usages of, any exchange, for future delivery; or engaged in the business of accepting or procuring the transmission of orders for such contracts of sale to be executed at an exchange, or under the rules or usages of an exchange, for future delivery. (6) Persons engaged in conducting an exchange or clearing house or clearing association for the clearing, adjusting, and settling transactions made on exchanges or similar places: Provided, That in case the person conducting such an exchange has a department connected therewith engaged in clearing, adjusting, and settling the transactions made on such exchange, he shall so state and shall give the names and addresses of the superintendent and secretary of each such clearing house division or committee. (b) If the person required to file a statement for registration is also a member of an exchange, a seat on which is worth $2,000 or more, he shall state the average value of such seat for the year ending June 30 immediately preceding his registration. (c) In the case of a partnership of which two or more members are members of exchanges, the names of such members and of each exchange in which memberships are held shall be stated, together with the price of a seat on each exchange. (d) The statement above required shall be verified on oath by the person required to make such statement, or by the president or secretary of a corporation, association, or clearing house, and shall set forth specifically the character of the business to be conducted and the full name and address of each person or member of a partnership engaged in such business: Provided, that in the case of a corporation or association, the statement for registration shall set forth the date and place of incorporation and the principal office or place of business both within and without the State where incorporated, and the names and addresses of the chief officer and secretary of such corporation, and be accompanied with a list of the members and their addresses. (e) Each exchange or clearing house shall also file with such collector a copy of its constitution, charter, or agreement of association and by-laws, rules and regulations, and all amendments thereto as the same may from time to time be adopted, and the names and addresses of new members as from time to time admitted to membership. (f) If the person or corporation required to file such statement has been licensed under the laws of any State or under any other provision of Federal law the date and place at

which such license was issued shall be stated. (g) In case a person registered as required by the regulations shall suspend or close his business before the end of the year for which he is registered, he shall file in the office of the collector of internal revenue in which he is registered a certificate to that effect, giving the date on which he suspended or closed his business. (h) Such statement for registration shall be made on a form to be furnished upon application to the collector of internal revenue.[395]

RECORD OF REGISTRATION KEPT BY COLLECTOR. (a) Every collector shall file and preserve each statement for registration filed with him in accordance with the regulations, and shall issue to each person, partnership, exchange, clearing house, or corpora-
name of the person, or exchange, clearing house, or corporation,
tion a certificate of registration, showing the date of issue, the conducting the business, the nature of the business for which the license is granted, and the date of expiration of said registry, which certificate of registration shall be signed by the collector, and shall be posted in some prominent place in the office of said person, partnership, exchange, clearing house, or corporation during the period for which it is issued. (b) If such business is conducted at more than one place, a certificate shall be posted in each place of business.[396]

Sale of Stamps. (a) No person other than a Collector of Internal Revenue, or duly authorized deputy collector of Internal Revenue, Assistant Treasurer, or designated United States depositary shall sell or expose for sale, give away, traffic in, trade, barter, lend, borrow, or exchange any stamps, issued pursuant to the regulations: Provided, That any person or corporation which has been duly appointed and constituted and is acting agent of any State for the sale of stock transfer stamps of such State, may upon giving bond in a sum to be fixed by the Commissioner, sell United States stamps issued pursuant to the regulations when approved and authorized by the Commissioner. (b) No person shall buy, receive, or have in his possession or under his control, any stamps issued pursuant to the regulations, unless such stamps have been purchased directly from the Collector of Internal Revenue, or duly authorized Deputy Collector of Internal

395 Reg. 40 Rev., Art. 34.
396 Reg. 40 Rev., Art. 35.

Revenue, Assistant Treasurer designated United States depositary, or a designated agent for the sale of State stock transfer stamps authorized by the Commissioner, in the district in which the stamps are to be used. (c) All requisitions for stamps to be used under these regulations shall be made in writing on a form prescribed by the Commissioner to the Collector of Internal Revenue or duly authorized Deputy Collector of Internal Revenue, Assistant Treasurer or designated United States depositary or State agent authorized by the Commissioner, in the Internal Revenue district in which the stamps are to be used, giving the date thereof, the number and denomination of stamps applied for and the name and address of the purchaser, and shall be signed in ink by the person receiving such stamps. (d) If the requisition for such stamps shall be made to any Assistant Treasurer or designated United States depositary or duly authorized State agent for sale of State stock transfer stamps, such Assistant Treasurer or designated United States depositary or duly authorized State agent shall keep a record thereof, and at the end of each month shall file with the Collector of Internal Revenue of the district a statement setting forth the number, denomination, and amount of all stamps on hand at the beginning of each month, the number, denomination and amount sold during the month, and the number, denomination and amount on hand at the end of the month, accompanied by the requisitions filed by each purchaser, and on or before the fifteenth day of each month shall pay over to such Collector of Internal Revenue all money received from sales of such stamps for the preceding month, taking his receipt therefor. (e) The Collector of Internal Revenue shall keep the requisitions for stamps sold by him and those sold by such Assistant Treasurer, designated United States depositary or authorized State agent separate and apart from all other requisitions for stamps and shall preserve them in his office for a period of two years.[397]

Penalties. Several penalties are provided in Title XI of the Revenue Act of 1918, which are dealt with in the following paragraphs. The act, omission, or failure of any official, agent or other person or corporation, employed by any person, partnership, company, association or corporation, within the scope of his

[397] Reg. 40 Rev., Art. 39.

employment or office, will in every case be deemed also the act, omission, or failure of such principal.[398]

Issuing or Accepting Unstamped Instruments. Anyone who makes, signs, issues or accepts an instrument without the full amount of the tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[399]

Consigning or Shipping Articles Without Paying Tax. Anyone who consigns or ships an article by parcel post without the full amount of tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[400]

Selling Playing Cards Without Paying the Tax. Anyone who manufactures and imports or sells any playing cards, package or other article without the full amount of tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[401]

Failure to Cancel Stamps. Anyone who makes use of a stamp without cancelling or obliterating the same is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[402]

Fraudulent Removal or Reuse of Stamps. The penalty for fraudulent removal or reuse of a stamp or having possession of washed, restored or altered stamps removed from any instrument is a fine of not more than $1,000 or imprisonment for not more

398 Reg. 40 Rev., Art. 33.

399 Revenue Act of 1918, §1102. The word "accept" is used in this section in the general sense of "receive," not in the special sense peculiar to drafts. (T. D. 2682.)

400 Revenue Act of 1918, § 1102.

401 Revenue Act of 1918, § 1102. The Act of August 28, 1894 also imposes the following penalties: § 39. Adhesive stamps to be affixed to each package, and canceled by the person using the stamp. Penalty, $50.00. § 40. Manufacturer to register with the collector of the district. Failure to register, penalty $50.00. § 42. Penalty for counterfeiting, defacing, or removing stamp or illegal use of the same, fine of $1,000.00, 5 years' imprisonment, or both, at the discretion of the court. § 43. Penalty for removal or sale of playing cards (except for export) without having stamp affixed, $50.00. § 44. Manufacturer removing or reusing any stamp, wrapper, or cover for the purpose of evading the tax liable to a fine of $50.00 and forfeiture. § 45. Penalty for selling or exposing for sale, removing, or concealing playing cards without having affixed the stamp thereto, $50.00 and forfeiture. (See T. D. 2817.)

402 Revenue Act of 1918, § 1102.

than five years or both, and the reused, cancelled or counterfeit stamp together with the document, package or article upon which it is placed or impressed may be forfeited to the United States.[403]

Transferring Stock Without Paying Tax. Any person liable to pay the tax on sales or transfers of capital stock or certificates of profits or any one acting as agent or broker for such person, who makes any sale, or in pursuance of a sale delivers any certificate or evidence of the sale of any stock, interest or right or bill or memorandum thereof, without the proper stamps affixed thereto with intent to evade the law is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[404]

Making Sales of Produce Without Paying Tax. Any person liable to pay the tax on sales of produce on any exchange or anyone acting as agent or broker for such person, who makes any sale, or agreement of sale or agreement to sell, or pursuant thereto, delivers any products or merchandise without a bill, memorandum or other evidence thereof, or who delivers such bill, memorandum or evidence, without having the proper stamps affixed thereto, is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[405]

Failure to Stamp Insurance Policies. Any person to or for whom or in whose name any insurance policy, taxable under Title XI is issued, or any solicitor, agent or broker acting for or in behalf of such person in the procurement of any such policy, for failure to affix the proper stamps with intent to evade the tax, in addition to other penalties provided herefor, will be obliged to pay a fine of double the amount of the tax.[406]

Other Penalties. The present law contains no provision that an unstamped instrument shall be void or shall not be admitted as evidence in the courts or shall not be placed on record. But Sections 13, 14 and 15 of the Act of June 13, 1898, as amended by the Act of March 2, 1901, are held by the Treasury Department to be still in force, and to apply to deeds to the extent that they

[403] Revenue Act of 1918, § 1103.
[404] Revenue Act of 1918, Title XI, Schedule A-4.
[405] Revenue Act of 1918, Title XI, Schedule A-5.
[406] Revenue Act of 1918, Title XI, Schedule A-15; T. D. 2891.

forbid the record and admission in evidence of unstamped deeds and require their presentation to the collector of the district for validation.[407] Section 13 makes provision for the stamping of documents issued without stamps; Section 14 that unstamped instruments are not admissible in evidence; and Section 15 that unstamped instruments shall not be recorded.[408] The provisions of these sections for refusing record and admission in evidence to unstamped deeds and their validation by collectors being still effective, to obviate any questions which might arise as to the validity of unstamped deeds, the proper course is to follow the procedure fixed therein.[409]

EXCLUDING UNSTAMPED DOCUMENTS IN STATE COURTS. There is some conflict of authority on the question whether the federal government has any authority under the constitution to prescribe rules of evidence for the state courts, and to preclude the acceptance in evidence of unstamped or improperly stamped instruments in the state courts. There are cases holding expressly that the federal government has such power, or holding to the same effect by excluding unstamped or improperly stamped documents,[410] but the weight of authority and the best considered cases seem to establish a contrary rule.[411] One of the best statements on the subject, contained in a Georgia case,[412] which arose under

407 Letter from Treasury Department dated May 27, 1918; W. T. S. 1919, ¶ 3717. §§ 2, 4, 6, 12, 18, 20, 21, 22, 23, 24, 25, Schedule A, Schedule B, §§ 27, 28, 29 and 50, of the Act of June 13, 1898, were expressly repealed by the Act of April 12, 1902. (32 Stat. 96.)

408 The sections are printed in full at the end of this book.

409 Letter from Treasury Department dated May 27, 1918; W. T. S. 1919, ¶ 3717.

410 Chartiers etc. Co. v. McNamara, 72 Pa. St. 278; Hoops v. Dunham, 41 Ga. 109.

411 Peo. ex rel. Barbour v. Gates, 43 N. Y. 40; Moore v. Moore, 47 N. Y. 467; Rowe v. Bowman, 183 Mass. 488, 67 N. E. 636; Davis v. Evans, 133 N. C. 320, 45 S. E. 643; Cassidy v. St. Germain, 22 R. I. 53, 46 Atl. 350; Garland v. Gaines, 73 Conn. 662, 49 Atl. 19; Clemens v Conrad, 19 Mich. 170; Sammons v. Halloway, 21 Mich. 162; Craig v. Dimock, 47 Ill. 308; Duffy v. Hobson, 40 Cal. 240; Pargoud v. Richardson, 30 La. Ann. 1286; Knox v. Rossi, 25 Nev. 96, 57 Pac. 179, 48 L. R. A. 305 (note). Many more cases could be cited to the same effect, but the above are leading cases, and it is believed that they will furnish a guide to a complete list of the authorities.

412 Small v. Slocumb, 112 Ga. 279; 37 S. E. 481. This case contains an ex-

the 1898 Law, of which the above sections 13, 14 and 15 once formed a part, reads as follows: "We fully recognize the power of Congress to levy and collect taxes for the support of the government. We fully recognize its power to do this by the imposition of stamp duties, and to prescribe penalties for their nonpayment. We also recognize its power to regulate the practice and procedure and to provide rules of evidence in courts established under the constitution of the United States. After much reflection and a careful and thorough investigation of cases in the courts of other States, we have come to the conclusion, however, that Congress has no power to prescribe rules of evidence for a State court. Under our system of government, the States retained all powers of sovereignty which were not granted to the general government by the constitution. They had the power to create and establish their own courts, and to regulate the practice and procedure, and to prescribe rules of evidence therein. There is nothing in the constitution of the United States, which expressly or by implication gives to Congress the power to prescribe rules of evidence for the courts of the States. Of course Congress, having the power to impose stamp duties, has the power to provide for the enforcement of their payment by any necessary and proper means. But while to make unstamped instruments inadmissible in evidence in State courts would doubtless aid in compelling the payment of the tax, we think that such a method of collection is neither necessary nor proper, and is therefore not within the power of Congress. The act of 1898 subjects to a penalty any one who fails or refuses to comply with the provisions as to stamping written instruments, and the Federal courts have ample machinery for the enforcement of this penalty. No other method of enforcement would seem to be necessary, but, even if it were, Congress has power to provide that no unstamped instrument shall be received in evidence in any of the Federal courts. An attempt to extend this provision so as to make it applicable to the courts of the several States can not, therefore, be defended upon the ground that it is necessary. Nor do we think it a proper means of enforcing the stamp act to interfere with courts peculiarly within the control of the several States, by declaring what shall or shall not be used as evidence in them, or to seek to make the State courts punish a failure to comply with the Federal stamp act by refusing to allow unstamped documents

to be used as evidence in them." These state decisions have no application to federal courts, where the laws of Congress, prescribing rules of evidence, must be observed.[413] And it has been held that even though a deed improperly stamped is admissible in evidence in the State courts, a purchaser at a judicial sale is entitled to a deed which will defend his title in any tribunal where it is attacked or where he is called upon to assert it, and that a referee to sell must affix the required stamps to his deed to such purchaser.[414]

VOIDING INSTRUMENTS FOR FAILURE TO STAMP. It is held that a deed, note or other instrument is not rendered absolutely void by a failure to stamp it properly,[415] but it is also held that such deed, note, or other instrument, is rendered void if the omission to stamp the same is wilful or with intent to evade the tax.[416] The point is in some confusion and no general rule can be safely formulated.

Suits for Collection of Stamp Taxes. Following the rule that the government may recover duties upon imports as a personal indebtedness of the importer, it has been held under the 1898 Law that there is nothing in the nature of a stamp tax which *per se* negatives either the personal obligation otherwise to be derived from the words imposing the tax, or its collection by action; (2) the stamp is only the evidence, and its purchase the convenient means, of payment, so that when a statute says that a person shall *pay*, it obviously imposes upon that person a *duty* to pay which may be enforced through the ordinary means adapted to the recovery of a definite sum due, unless that course is clearly prohibited, (3) the penalties contained in the act were provided to induce the payment of the tax and not as a substitute for payment, and such provisions do not preclude the

haustive examination of the authorities, and expressly disapproves of Chartiers etc. Co. v. McNamara, 72 Pa. St. 278.

413 Sackett v. M'Caffrey, 131 Fed. 219.

414 Loring v. Chase, 26 Misc. 318; 56 N. Y. Supp. 312.

415 Moore v. Moore, 47 N. Y. 467; Goodwine v. Wands, 25 Ind. 101; Adams v. Dale, 29 Ind. 273; D'Armond v. Dubose, 22 La. Ann. 131.

416 Dowell v. Applegate, 7 Fed. 881; Rewe v. Bowman, 183 Mass. 488, 67 N. E. 636; Cassidy v. St. Germain, 22 R. I. 53, 46 Atl. 350; Hooper v. Whitaker, 130 Ala. 324, 30 So. 355; Harvey v. Wieland, 115 Ia. 564, 88 N. W. 1077; Ohio R. Junc. R. R. Co. v. Penna. Co., 222 Pa. St. 573, 72 Atl. 271.

idea of personal liability; (4) the punitive provisions invalidating unstamped instruments offer an escape through a voluntary payment and therefore do not deprive the government of the right to compel payment by action; (5) the act itself provides by reference to the Revised Statutes and the administrative. special or stamp provisions of law that payment may be enforced by action.[417]

Constitutionality of Stamp Taxes. The constitutionality of various stamp tax acts has only been attacked on certain grounds and in reference to particular clauses, and no general deduction can be made as to the constitutionality of the present statute *in toto*. In one of the leading cases on the subject[418] it was decided that the 1898 Law was valid, in so far as it placed a stamp tax upon sales, agreements of sale, or agreements to sell any products or merchandise at any exchange or board of trade, or other similar place, either for present or future delivery. The court held that the tax was not a direct tax, but a duty or excise tax laid upon the privilege or opportunity afforded by boards of trade or exchanges for the transaction of business, although the amount of the tax was measured by the value of the property sold; and that it was immaterial that the tax could not be added to the price of the thing sold. The tax was also held to be uniform both in the geographical sense and in the sense that it taxed all taxpayers similarly situated, since there was a reasonable basis of classification in taxing all sales on exchanges. The court ruled further that the tax was not invalid or discriminatory (a) because it applied only to sellers and not to purchasers (b) because it did not tax the same privilege when used for all purposes, and (c) because it required a person selling property in intra-state commerce to make a memorandum, this being a proper means for the collection of the tax and a legislative question. The stamp tax on a memorandum or contract of sale of a certificate of stock imposed by the 1898 Law was held not to be a direct tax but to fall within the class of duties, imposts and excises permitted under the first clause of Section 8 of Article 1 of the Constitution.[419] It had been held that the statute[420]

[417] U. S. v. Chamberlin, 219 U. S. 250.

[418] Nicol v. Ames, 173 U. S. 509.

[419] Thomas v. U. S., 192 U. S. 362. For a full discussion of the subject see the opinion of the lower court, 115 Fed. 207.

[420] R. S. § 3173.

giving the Commissioner of Internal Revenue power to require persons, who fail or refuse to make proper returns for stamp tax as well as other tax purposes, to produce their books, is not unconstitutional, since an order to produce books is not violative of the rights of a witness, though such rights may be invaded after his appearance.[421] In a recent case[422] it was contended that the 1914 Law was unconstitutional and void if it imposed a tax of any kind upon the deed given by a referee in pursuance of the order and as a part of the procedure of a State Court. It was held that the Act was not invalid in this respect as imposing a tax on the state's exercise of its governmental functions, since the tax imposed was an excise tax on the business transaction involved in the purchase of the land from the referee and its transfer to the purchaser, and that the transfer was in its nature the same as any transfer from one individual to another. But the 1898 Law so far as it attempted to impose a tax on charter parties used exclusively for the carriage of cargo from ports in the United States to foreign ports, was held to be a direct, and not incidental, tax on exports or exportation and, therefore, in this respect unconstitutional.[423] It is probable that the present law would not be upheld if it were construed in any way to place a tax upon exports or exportation.[424] And it seems that any construction of Sections 13, 14 and 15 of the 1898 Law, which are held to be still in force,[425] whereby unstamped or improperly stamped deeds, notes or other instruments, were denied admission in evidence in State courts would render the section unconstitutional as an attempt on the part of the federal government to prescribe rules of evidence for the State courts.[426]

[421] Calkins v. Smietanka, 240 Fed. 138.

[422] Home Title Ins. Co. v. Keith, 230 Fed. 305. This case contains a lenghty discussion of the authorities holding in favor of the constitutionality of the statute.

[423] U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003.

[424] See T. D. 2682. Letter from Treasury Department dated April 13, 1918; W. T. S. 1918, ¶ 3707; letter from Treasury Department dated January 24, 1918; W. T. S. 1918, ¶ 3683.

[425] Letter from Treasury Department dated May 27, 1918; W. T. S. 1918, ¶ 3723.

[426] See paragraph on Excluding Unstamped Documents in State Courts, p. 819.

Consequently such sections probably apply only to the federal courts, since it is a well known rule of statutory construction that where a statute admits of two constructions one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question, the courts tend to adopt the latter interpretation.[427] An amendment to the stock transfer act of New York imposing a tax of 2 cents "*on each share* of one hundred dollars of face value or fraction thereof" instead of "on each one hundred dollars of face value or fraction thereof" as provided in the original law was held unconstitutional on the ground that such amendment taxed the sale of all shares of the face value of one hundred dollars and also all shares of the face value of any fraction of one hundred dollars, the words "fraction thereof" being held to relate to "share" rather than to "one hundred dollars"; and that therefore the tax was measured by the number of shares regardless of face value instead of the face value of the shares; that all corporate shares were placed in a class but all members of the class were not treated alike; that the statute bore heavily upon some and lightly upon others in the same situation without method or order or reason and resulted in arbitrary or accidental selection rather than classification. While wide latitude in classification is possessed by the legislature, this power is not without the limitation that any classification adopted must have some basis, reasonable or unreasonable, other than mere accident, whim or caprice and must not result in an arbitrary discrimination in favor of one as against another of the same class. So far as the tax on the issue and sales or transfers of certificates or shares without par or face value of which the actual value does not exceed $100 per certificate or share is concerned, the Revenue Act of 1918, like the above unconstitutional amendment imposes a tax without reference to the actual value of the certificates or shares issued or transferred and in many cases would seem to constitute arbitrary selection rather than constitutional

[427] See paragraph Construction Which Will be Constitutional in the chapter on Construction of the Law. In Sackett v. M'Caffrey, 131 Fed. 219, the court declined to discuss the correctness of the state decisions adopting the interpretations of §§ 13, 14, and 15 of the Act of June 13, 1898, which restrict the prohibition against the admission of unstamped documents as evidence to the federal courts and thus saves the sections from unconstitutionality.

classification.[428] In construing the 1914 Law as imposing a tax upon the issue of certificates of shares issued by a manufacturing company organized in the form of a trust under the common law and deriving none of its rights, benefits or qualifications from any statute, and which was not an ordinary common law real estate trust, the Court has sustained the constitutionality of the law, holding it not invalid on the theory that it was inapplicable to other associations. The tax was stated to be merely on muniments of title so that, if other associations did not issue such muniments of title, they were accordingly not taxable.[429]

Payment Under Protest and Duress. The general rule of law, that a voluntary payment of money cannot be recovered, applies to stamp taxes. A person, theerfore, who wishes to recover the amount of any stamp tax, which he considers illegally exacted, should pay the tax under protest and such payment should be involuntary and under duress. Stamp taxes paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, may on occasion be recovered, although generally speaking even a protest or notice will not avail if the payment be made voluntarily with full knowledge of the circumstances and without any coercion by the actual or threatened exercise of power possessed by the party exacting or receiving the payment over the person or property of the party making the payment from which the latter has no other means of immediate relief than such payment. The rule is firmly established that stamp taxes voluntarily paid cannot be recovered back and that payments with knowledge and without compulsion are voluntary. Thus, in a case[430] in which certain stamps were purchased from the collector who was not informed when the purchase was made of the particular purpose and who was given no intimation of any claim that the purchaser was acting under duress, recovery was denied even though the purchaser affixed the stamps in order to complete the transaction between himself and the vendee named in the deed to be stamped and to obtain the consideration for the property transferred. It was held that this

[428] Peo. v. Mensching, 187 N. Y. 8.
[429] Malley v. Bowditch, 259 Fed. 809.
[430] Chesbrough v. U. S., 192 U. S. 253.

transaction, while it might have constituted duress as between the parties to the deed, was a matter with which the collector had nothing to do and that the payment to the collector for the stamps was purely voluntary. The written application to the Commissioner to recover the amount paid for the stamps was held not to be the statutory equivalent of a common-law protest or notice of suit. While the Commissioner under the Revised Statutes[431] might have refunded the amount of such tax, an appeal was not permitted from his refusal to refund because it was not a ruling either specific or resulting from a demand, to which the taxpayer yielded under the protest and with notice, and from which he appealed to the Commissioner of Internal Revenue. Likewise, where a stamp tax was paid on manifests of cargoes on certain vessels bound to foreign ports as required by the 1898 Law, no information having been given to the person from whom the stamps were bought of the particular purpose, or claim made to the collector or Commissioner that the tax was unconstitutional, and no claim having been made to the collector of the port of New York that the taxpayer was acting under restraint and yielding only to enable his ship to depart. recovery was denied because the tax was not paid under duress, even though clearance papers could not be procured without the delivery to the collector of the port of outward foreign manifests of cargo properly stamped, and even though the master of a vessel failing to deliver the proper manifest and to obtain a clearance, was subject to a penalty.[432]

Injunctive Relief. The general rule that a taxpayer may not resort to a suit to restrain the assessment or collection of any tax applies to stamp taxes and a taxpayer is not entitled to an injunction to restrain the Commissioner of Internal Revenue from assessing the taxes on sales of grain to which no stamps have been affixed, the only remedy to the taxpayer in such case being by suit to recover the tax.[433]

431 R. S. § 3220.
432 U. S. v. N. Y. & Cuba etc. Co., 200 U. S. 488.
433 Calkins v. Smietanka, 240 Fed. 138. See R. S. §§ 3224, 3226.

CHAPTER 46

TAX ON EMPLOYMENT OF CHILD LABOR

This tax is a new feature of the internal revenue laws of the United States, designed to effect the abandonment of child labor in the establishments specified in the law.[1]

Effective Date of the Act. The tax goes into effect beginning sixty days after the passage of the Revenue Act of 1918.[2] The Revenue Act of 1918 was signed by the President on February 24, 1919, and the effective date is therefore April 25, 1919. The first taxable year, that is, the taxable year 1919, consists of the period between April 25, 1919, and December 31, 1919, both inclusive, or any fiscal year ending within the same period.[3]

Persons to Whom the Tax Applies. The tax applies to any individual, corporation, partnership, association, joint-stock company, or insurance company operating a (1) mine, (2) quarry, (3) mill, (4) cannery, (5) workshop, (6) factory or (7) manufacturing establishment situated in the United States (except only a boys' or girls' canning club duly recognized by a State Agricultural Department or United States Agricultural Department).[4]

Mill, Cannery, Workshop, Factory or Manufacturing Establishment. In the case of these establishments the tax applies if (a) any child between the ages of 14 and 16 (presumably both ages inclusive) has been employed or permitted to work more than eight hours in any day or more than six days in any week or before six o'clock a. m. or after seven o'clock p. m.; and (b) if any child under the age of fourteen has been employed or permitted to work at all.[5] The term "workshop, factory, or manufacturing establish-

1 Revenue Act of 1918, Title XII.

2 Revenue Act of 1918, § 1207.

3 Reg. 46, Art. 5.

4 Revenue Act of 1918, § 1200; Reg. 46, Art. 2.

5 Revenue Act of 1918, § 1200; Reg. 46, Art. 3. The term "under the age of fourteen years" is meant to include all children who have not yet reached their fourteenth year. The term "eight hours in any day" means the actual

ment" includes bakeries, blacksmith shops, boxmaking establishments, steam laundries, and stonecutting.[6] The term "manufacturing establishment" includes bottling plants, gas companies,[7] ice factories,[8] meat markets engaged in the manufacture of meats for local trade, newspaper publishing plants or companies,[9] timber cutting in woods and logging force operations connected with the operation of a manufacturing establishment.[10] The following are not included within these terms: drug stores (retail); express companies; grocery stores (retail); mercantile stores not connected with taxable establishments; moving picture business, either in studio or out of doors; telegraph offices, in respect of boys and messengers; telephone companies; trust and title companies; tobacco plantations (cutting and stringing tobacco leaves); commissaries operated by sawmills.[11] Some additional rulings in particular industries are indicated below.

EMPLOYMENT IN GENERAL AND FACTORY OFFICES. The terms workshop, factory, or manufacturing establishment as used in the

period of employment and shall be reckoned from the time the child is required or allowed to be at the place of employment until he or she stops work for the day, exclusive of one continuous period of a definite length of time during which the child is off work and not subject to call for duty of any kind. The term "six days in any week" means six consecutive days, no one of which shall consist of more than eight hours of working time. A "day" must not begin before 6 o'clock a. m. and must not extend beyond 7 o'clock p. m. (Reg. 46, Art. 1.)

6 Letters from Treasury Department dated June 14, 1919; April 1, 1919; April 1, 1919; June 9, 1919; and August 2, 1919, respectively.

7 The employment of boys between 14 and 16 years to light and extinguish street lamps does not render a gas company subject to tax if their presence in and about the gas factory premises is not required or permitted.

8 This ruling refers to the employment of boys to accompany delivery wagons and carry ice into houses.

9 The employment of children in the distribution of papers outside and away from the manufacturing establishment does not come within the purview of the statute.

10 Letters from Treasury Department dated May 28, 1919; May 21, 1919; April 12, 1919; May 5, 1919; and May 27, 1919 respectively.

11 Letters from Treasury Department dated May 2, 1919; May 1, 1919; May 15, 1919; May 2, 1919; June 14, 1919; June 21, 1919; April 1, 1919; May 31, 1919; May 7, 1919; May 8, 1919; June 20, 1919; May 21, 1919. The presence of child employees of the company, however, in or about a sawmill premises contrary to the standards laid down by the statute would subject the person operating the mill to the tax.

Child Labor Tax Law, clearly mean the premises on which the manufacturing business is conducted, including the buildings and grounds. The terms in their ordinary sense include whatever is necessary to carry on the mechanical operation or process. Any part essential to the conduct of a manufacturing business is as much a part of a manufacturing establishment as the buildings in which the machinery is housed, or the ground occupied by the buildings. A factory office, therefore, is a part of the establishment and no distinction can be made in employment in different departments. The duties of office employees frequently take them into and often require their presence in the plant or manufacturing part of such establishments when they are accessible. Actual employment in the manufacturing or production part of a plant is not necessary, and it is not possible to exempt from the application of the law any occupation or class of employment connected with the operation of the establishment specified. The law applies if children are employed in or about the establishment. An office which occupies the top floor of a factory building of a manufacturing and selling company would come within the application of the law, and if children under 14 years are employed, or if children between 14 and 16 years are permitted to work more than eight hours in any day or more than six days in any week, or before 6 a. m., or after 7 p. m., the person operating the establishment would be subject to the imposition of the tax. Office employees as a class and apart from the operation of the establishments specified are not believed to be within the taxation intent of the Child Labor Tax, and the provisions of this act do not apply to the employment of children in a general office, a main office, or district office established purely for office purposes, in no way a part of the manufacturing establishment as defined, but conducted solely as a city office whose employees under the age of 16 years are never required or permitted or suffered to be in or about the manufacturing establishment.[12]

AGRICULTURAL AND FORESTRY OPERATIONS. The statute does not apply to the agricultural industry, even though it may be part of a complete industrial cycle, or to forestry operations. A sugar-mill and sugar-cane plantation may be operated as a unit, but the law

[12] Letters from Treasury Department dated May 31, 1919; May 2, 1919; and June 26, 1919.

does not apply to the labor employed in the production of the cane. The employment of children contrary to the terms of the law in or about the mills would subject the person operating the mill to the imposition of the tax, but employment or permission to work of children in the fields in purely farming or agricultural operations does not come within the taxation intent of the law.[13] But the snipping of beans or husking of corn for canning, even though carried on at some distance from the cannery proper, is an essential part of the business. Beans are snipped and corn husked as a necessary part of a canning operation and not a necessary part of an agricultural operation. Farming or agricultural work may cease and be complete with the production and picking or gathering of beans and corn, but when these vegetables are prepared and broken, snipped or husked, with a view to their immediate use in canning or preserving, for public sale, the snipping and husking, wherever carried on—in the fields, in sheds or shelters on the farm, in farm houses, or in sheds and shelters near the canneries—are a part of a cannery operation and the children employed on such work are employed in a cannery within the meaning of the law.[14] The employment of children in carrying on forestry operations in turpentine woods—such as distributing the "cups" or receptacles to catch the crude gum, or collecting the cups or receptacles, or dipping or removing the crude gum from the collecting receptacles and transferring it to buckets and thence to barrels, or raking dead leaves and rubbish away from the pine trees, or serving as water boys—occupations which are physically separate and wholly apart from the still or manufacturing establishment and from the character of the work would not permit the children to be in or about the still or manufacturing establishment, does not subject the employer to the tax.[15] The employment of children in the woods, as chain carriers for land surveyor and timber estimator, the nature of their employment never requiring or permitting their presence in or about the mechanical operations essential to the sawmill industry, does not come within the taxation intent of the law, and would not subject the person operating the sawmill to the tax.[16]

13 Letters from Treasury Department dated April 12, 1919, and May 2, 1919.

14 Letter from Treasury Department dated June 26, 1919.

15 Letter from Treasury Department dated July 7, 1919.

16 Letter from Treasury Department dated May 22, 1919.

VACATION PERIOD. There is no exemption under the Child Labor Tax law for the vacation period.[17]

CHILDREN IN COMPANY OF MOTHERS. The presence of any child in or about any of the establishments specified in the law will be taken as *prima facie* evidence of its employment therein. It is immaterial that the children are in or about the establishments with their mothers and are entirely too young to work or be of service there.[18]

SON OF PROPRIETOR. A tax is imposed on every person operating a mill, cannery, workshop, factory, or manufacturing establishment in which children under the age of 14 years are employed or permitted to work. No distinction can be made under the law in the matter of the owner's children.[19]

JANITOR SERVICE IN OFFICE OF MANUFACTURING PLANT. No distinction can be made in the kind of occupation or employment in any of the establishments specified in the Child Labor Tax law. A factory office is a part of the factory, and where children under 14 years of age are employed to do sweeping and cleaning in the office of a manufacturing plant during any portion of the year, the person operating such establishment is subject to the tax imposed.[20]

Mine or Quarry. In the case of a mine or quarry, the tax applies if any child under the age of 16 years has been employed or permitted to work therein.[21]

IN OR ABOUT MINES. The term mining premises as applied to the Child Labor Tax Law is held to mean any property used in mining operations—that is, the mining lands in which the deposits of minerals are worked by ordinary mining processes—and is limited to the grounds and buildings used in the operation of the mine. The different departments of the mining premises, such as work on tipples, breakers, tracks, in mine office, carrying messages from department to department, hauling materials to and from the mines, or any other operation connected with the

17 Letter from Treasury Department dated May 27, 1919.

18 Letter from Treasury Department dated June 4, 1919.

19 Letter from Treasury Department dated May 31, 1919.

20 Letter from Treasury Department dated May 16, 1919.

21 Revenue Act of 1918, § 1200; Reg. 46, Art. 3. The term "under the age of sixteen years" is meant to include all children who have not yet reached their sixteenth year. (Reg. 46, Art. 1.)

whole mode of obtaining metals or minerals for commercial purposes, come within the purview of the law. Stores and other enterprises outside and away from the mining operations, though owned and controlled by the mining company, are not considered necessary to carry on the mechanical operation or process of the mine and the provisions of section 1200 relating to mines do not apply to the employment of children in such places, the character of the work never requiring or permitting their presence in or about the mines. Making of mine props and cutting of ties or the manufacture of other material purchased for use in a mine is not part of the mining process and the law relating to employment of children in mines would not apply. If, however, such work is done in connection with the operation of a sawmill or lumber mill, or other manufacturing establishment, the law pertaining to mills and manufacturing establishments would apply. If the grading of a road takes a child employee under 16 years in or about a mine, the person operating the mine will be liable to the tax. If the work of grading a road does not require the child to be in or about the mine, his employment will not subject the mine operator to the tax. The tax is not imposed on the employment of children at road grading, nor is it imposed on a mining company for employment of children under 16 everywhere, but it is imposed upon the mine operator if children under 16 years are employed in or about the mines.[22]

COKE OVENS. A coke plant is not considered a part of a mining industry but is held to be a manufacturing establishment within the meaning of the law.[23]

Time (Sun or Clock). The Act of Congress approved March 19, 1918, entitled "An act to save daylight and to provide standard time for the United States," provides that "In all Statutes * * * relating to time * * * within which any act shall or shall not be performed by any person subject to the jurisdiction of the United States, it shall be understood and intended that the time shall be the United States standard time of the zone within which the act is to be performed." The standard of hours relating to the employment of children must be determined in accordance with the provisions of the law on this point, and the

22 Letter from Treasury Department dated August 2, 1919.
23 Letter from Treasury Department dated June 21, 1919.

United States standard time of the zone in which a mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment is located will govern in the enforcement of the Child Labor Tax Law.[24]

Duration of Employment. Liability for the tax is established by the employment of any child laborer. The product of the child's labor is not the basis for the imposition of the tax. The tax is applied to the entire net income of the taxable establishment.[25] Employment contrary to the provisions of the act for a single day is sufficient to impose the tax on the net profits for the whole taxable year.[26]

Certificate of Age. Any person subject to the provision of the law who in good faith obtains a certificate at the time of employment showing the child to be of such age as not to come within the purview of the law, and keeps such certificate on file, may rely in good faith on such certificate to relieve him from the tax. Such certificate is to be issued in such form, under such conditions, and by such persons as may be prescribed by a board composed of the Secretary of the Treasury, the Commissioner of Internal Revenue and the Secretary of Labor. The board may also authorize the use of employment certificates or other similar papers as to the age of the child issued under the laws of any State designated by the board.[27] This board has prescribed the following regulations: Certificates of age, in order to free from liability to taxation persons operating the business specified, shall be either: (a) Federal age certificates for children between 14 and 16 years of age when employed or permitted to work in any mill, cannery, workshop, factory, or manufacturing establishment, and for children between 16 and 17 years of age when employed or permitted to work in or about any mine or quarry. Such certificates shall bear (1) the child's name; (2) birthplace; (3) month, day, and year of birth; (4) color; (5) sex; (6) kind of evidence of age accepted and age when physical age is accepted; (7) signature of the child; (8) name and address of child's parents, guardian, or custodian;

[24] Letter from Treasury Department dated May 2, 1919.

[25] Reg. 46, Art. 3.

[26] See Revenue Act of 1918, §§ 1200 and 1207.

[27] Revenue Act of 1918, § 1203 (a).

(9) name and address of employer; (10) signature, address, and official designation of agent issuing the certificate; (11) date and place certificate was issued. (b) An age certificate, working or employment certificate or permit, or other similar paper as to the age of the child, issued in accordance with the laws of the State in such States as are designated by the board.[28]

Proof of Age. Age-certificate inspectors authorized to issue Federal certificates of age shall do so only after securing, examining, and approving proof of age as follows: The child shall make application to the age-certificate inspectors in person, accompanied by parent, guardian or custodian, with documentary evidence of age, showing that he is 14 years of age or over if the employment is to be in a mill, cannery, workshop, factory, or manufacturing establishment, or that he is between 16 and 17 years of age if employment is sought in or about a mine or quarry. Documentary evidence of proof of age, required in the order following, shall be: (a) A birth certificate or duly attested transcript thereof issued by the registrar of vital statistics or other officer charged with the duty of recording births. (b) A baptismal certificate or transcript of the record of baptism, duly certified, showing the date of birth and place of baptism of child. (c) A *bona fide contemporary* record of the date of the child's birth, comprising a part of the family record of births in the Bible, or other documentary evidence satisfactory to the board, such as a certificate of arrival in the United States issued by the United States immigration officers and showing the age of the child, a passport showing the age of the child, or a life insurance policy: Provided, that such other satisfactory documentary evidence has been in existence at least one year, and in the case of a life insurance policy at least four years: And provided further, that a school record or a parent's, guardian's, or custodian's affidavit or other written statement of age shall not be accepted except as specified in paragraph (d). (d) A certificate signed by a public-health physician or a public-school physician, stating, in his opinion, the physical age of the child. Such certificate shall show the height and weight of the child and other evidence of physical age revealed by the physician's examination or upon which the opinion of the physician is based. A

28 Reg. 46, Art. 8.

parent's, guardian's, or custodian's signed statement as to the age of the child, and a record of age as given on the register of the school first attended by the child, or in any school census, if obtainable, shall be submitted with the physician's certificate showing physical age. No certificate shall be issued if the physician's certificate of physical age or the parent's statement or the register of the school first attended or the school census shows the child to be under the age of 14 if employment in a mill, cannery, workshop, factory, or manufacturing establishment is contemplated, or under the age of 16 if employment in a mine or quarry is contemplated. The agent issuing the age certificate for a child shall require the evidence of age stated in paragraph (a) in preference to that specified in any subsequent paragraph, and shall not accept evidence of age permitted by any later paragraph unless he shall receive and file evidence that the proof of age required by the preceding paragraph or paragraphs can not be obtained.[29]

Acceptance of State Certificates. States in which age certificates, or working or employment certificates, permits or other similar papers as to the age of the child are issued under State authority, substantially in accord with the requirements of this act and these regulations may be designated as States in which such certificates have the same force and effect as Federal age certificates, *except as the acceptance for the purposes of the statute of individual certificates may be suspended or revoked.* Certificates, permits, or other similar papers in States so designated shall have the same effect as Federal age certificates so long as they shall remain in force, the Commissioner or such person as he may designate possessing the right to suspend or revoke the acceptance for the purposes of this act of individual certificates at any time. Certificates imposing restrictions or conditions in addition to the requirements of the Federal law or of the regulations shall not be held inconsistent with the law.[30]

Mistake as to Age of Child. If a child has been employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax, such employment will not cause the tax to be imposed.[31]

[29] Reg. 46, Art. 9.
[30] Reg. 46, Art. 10.
[31] Revenue Act of 1918, § 1203 (b).

Inspection of Establishments. The Commissioner, or any person authorized by him, may enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, has like authority to make inspections for the purpose of complying with a request of the Commissioner.[32]

Basis and Rate of Tax. The statute imposes an excise tax which is in addition to all other taxes imposed by law at the rate of 10% on the entire net profits received or accrued during any taxable year in which child labor is employed for any period of time, as indicated in the law. The net profits are computed by deducting from the gross amount received or accrued during the taxable year from the sale or disposition of such products manufactured within the United States (a) the cost of raw materials entering into the production; (b) running expenses, including rentals, repairs, maintenance, heat, power, insurance, management, and a reasonable allowance for salaries and depreciation; (c) interest on money borrowed and used to meet the needs of the business; (d) taxes of all kinds paid during the taxable year with respect to the business or property relating to the production and (e) losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm or other casualties, not compensated for by insurance or otherwise. If the product is sold at less than the fair market price in such manner as to directly or indirectly benefit any person directly or indirectly interested in the business or with intent to cause such benefit, the tax is imposed on the gross amount received or accrued from the sale or disposition during the period that any such sales took place.[33]

Returns to Be Filed. Every person subject to the provisions of the law (which seems to mean those who operate establishments of the kind enumerated in the law) is required to file a return annually showing the gross amount of income received or accrued during the year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment in which children have been employed subjecting him to the tax and the amounts allowed by the law to be deducted

[32] Revenue Act of 1918, § 1206.
[33] Revenue Act of 1918, §§ 1200, 1201, 1202; Reg. 46, Art. 3.

therefrom, and other particulars, in such form as the Commissioner may require. Such returns are to be filed on or before the first day of the third month following the close of each taxable year, with the local collector. Extension of time to file returns may be granted by the collector in case of sickness or absence.[34]

Tax Due. The collector transmits forthwith all returns to the Commissioner, "who shall, as soon as practicable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before 30 days from the date of such notice."[35]

Time Record. A time record should be kept daily by persons operating any mill, cannery, workshop, factory, or manufacturing establishment, showing the hours of employment for each and every child who has completed the fourteenth year but has not yet completed the sixteenth year of its age, whether employed on a time or a piece rate basis. Certificates of age for children employed in any mill, cannery, workshop, factory, or manufacturing establishment may be suspended or revoked for failure on the part of the person operating the same to keep time records as required by this regulation or for false or fraudulent entries made therein.[36]

Penalties. The general penalties apply for failure to file returns, or pay the tax, or for filing false or fraudulent returns.[37] Refusal to permit entry or inspection of any establishment is punished by fine of not more than $1,000 or imprisonment for not more than one year, or both fine and imprisonment.[38] Any person who knowingly makes a false statement or presents false evidence in or in relation to any certificate of age or application therefor will be subject to a fine of not less than $100 nor more than $1,000, or to imprisonment for not more than three months, or to both such fine and imprisonment.[39] Actions to enforce these pen-

[34] Revenue Act of 1918, § 1204; R. S., § 3176; Reg. 46, Art. 4.

[35] Revenue Act of 1918, § 1205; Reg. 46, Art. 6.

[36] Reg. 46, Art. 11.

[37] See Revenue Act of 1918, §§ 1308 and 1317, containing R. S., § 3176, as amended.

[38] Revenue Act of 1918, § 1206.

[39] Revenue Act of 1918, § 1203.

alties will be brought in the federal courts by the United States District Attorney of the Federal Judicial District in which the offense occurs.[40]

Constitutionality of Child Labor Tax. The Supreme Court of the United States has declared unconstitutional the so-called Child Labor Law, which prohibited the transmission in interstate commerce of products of child labor.[41] The present excise tax equivalent to 10% of the net profits received from the sale of products of establishments employing child labor is intended to accomplish the same object which the former law was unable to reach.[42]

[40] Reg. 46, Art. 7.

[41] Hammer v. Dagenhart, 247 U. S. 251. The Supreme Court was considerably divided in this decision. Mr. Justice Day delivered the majority opinion which was concurred in by Mr. Justice Van Devanter, Mr. Justice Pitney, Mr. Justice McReynolds and Chief Justice White. Mr. Justice Holmes delivered a dissenting opinion which was concurred in by Mr. Justice McKenna, Mr. Justice Brandeis and Mr. Justice Clarke.

[42] It has been decided by a Federal District Court that the Child Labor Title of the Revenue Act of 1918 is also unconstitutional and this case is now in process of appeal to the United States Supreme Court.

CHAPTER 47

CONSTRUCTION OF TAXING STATUTES

It is beyond the scope of this chapter to discuss at great length the numerous rules of statutory construction. The following paragraphs will indicate briefly rules especially applicable to revenue statutes which may be of assistance in the interpretation of such ambiguities as are encountered in our present system of income, excess-profits and other tax laws. Wherever possible the citation of authorities has been confined to cases arising under various revenue laws of the United States.

Although a statute may be construed contrary to its literal meaning when a literal construction would result in an absurdity, inconsistency, or in glaring inequality, and palpable injustice, where its language is susceptible of more reasonable, though perhaps less natural, construction which carries out its spirit rather than letter,[1] it is a well-settled general rule that a legislative act must be interpreted according to the intention of the legislature apparent upon its face.[2] Construction and interpretation have no place where the language of a statute is unambiguous and its meaning evident.[3] Arguments as to the expediency of a tax law or the possible economic mistake or wrong involved in the tax imposed thereby[4] or the inequality thereof,[5] are beyond judicial cognizance.[6] To ascertain the

1 Stratton's Independence v. Howbert, 231 U. S. 399; Knowlton v. Moore, 178 U. S. 41, 77; Treat v. White, 181 U. S. 264; Seenon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609.

2 Wilkinson v. Leland, 2 Pet. 627; U. S. v. Union Pacific R. R. Co., 91 U. S. 72.

3 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961, writ of certiorari denied 201 U. S. 645.

4 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Blunt v. U. S., 255 Fed. 332.

5 Billings v. U. S., 232 U. S. 261; 255 Fed. 332.

6 In Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, the Court said: "With the political or economic policy or expediency of the law

intention of the legislature the first resort is to the grammatical sense and the natural, ordinary and familiar meaning of the words employed,[7] and it is particularly true that terms used in statutes describing objects of taxation should be construed according to the popular acceptation of the terms they employ rather than by refined or strained analogies.[8] The presumption is that language has been employed with sufficient precision to disclose the intention of the legislature and unless this presumption is overthrown, nothing remains but to enforce the statute as written.[9] If, however, it is apparent on the face of the statute, or from its context, that a term of common use and meaning is intended to bear some other signification, it may be interpreted accordingly.[10] For instance, it is the duty of those construing a statute to give effect to the clear intention of those passing it, and to do this it is common practice to read the words "and" and "or" convertibly.[11] The word "false" may be construed to mean either incorrect but in good faith [12] or incorrect with fraudulent intent.[13] Words having a fixed legal meaning are presumed to have been used in such sense.[14] Commercial and trade terms, which belong exclusively to the vocabulary of merchants and traders or which are shown to have a certain, uniform and general meaning in commerce and trade different from their ordinary meaning, will be interpreted accordingly.[15] Gen-

we have nothing to do. If it be within constitutional lines, it represents and embodies public policy, because it is enacted by that branch of the government which determines public policy." See State ex rel. Wisconsin Trust Company v. Widule, 164 Wis. 56.

7 Treat v. White, 181 U. S. 264; Schriefer v. Wood, 21 Fed. Cas. No. 12,481; U. S. v. Isham, 17 Wall. 496; U. S. v. Chesbrough, 176 Fed. 778; Seldon v. Equitable Trust Co., 8 Fed. Cas. No. 4,508, affirmed 94 U. S. 419.

8 Nix v. Hedden, 39 Fed. 109, affirmed 149 U. S. 304; De Ganay v. Lederer, 239 Fed. 568.

9 Mannington v. Hocking Valley R. R. Co., 183 Fed. 133.

10 U. S. v. Chesbrough, 176 Fed. 778.

11 U. S. v. Fisk, 3 Wall. 445. But the word "and" is never construed to mean "or" in the absence of cogent reasons for so doing.

12 National Bank of Commerce v. Allen, 223 Fed. 472; Eliot National Bank v. Gill, 218 Fed. 600.

13 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961.

14 U. S. v. Fidelity Trust Co., 222 U. S. 158; Nat. Life & Accident Ins. Co. v. Craig, 251 Fed. 524.

15 Maddock v. Magone, 152 U. S. 368; Sonn v. Magone, 159 U. S. 417.

erally, a descriptive trade term used in the act will be given the special meaning attaching to it at the time the act was passed,[16] but in some cases a later and broader meaning may be adopted if warranted by commercial usage and the general language of the statute.[17] General terms following special terms are, as a rule, limited in scope and meaning to the same general class as the special terms; in other words, the particular words are presumed to describe certain species and the general words to be used to include other species of the same genus.[18] But this is only a rule of construction to aid in arriving at the real legislative intent. It is not a cast-iron rule, overriding all other rules of construction, and it will never be applied to defeat the real purpose of the statute as gathered from its entire context. While the rule is aimed to preserve a meaning for the particular words, it should not be permitted to render meaningless the general words. Therefore, where the particular words exhaust the class, the general words must be construed as embracing something outside of that class. If the particular words exhaust the class, there is nothing *ejusdem generis* left, and in such case the general words must be given the meaning outside of the class indicated by the particular words, otherwise the meaning of the general words would be sacrificed to preserve the particular words and the rule would defeat its own purpose.[19] The general rule of construction applicable to all statutes and written instruments that words should be given the meaning naturally attaching to them from their context and that a word of obscure meaning, taken by itself, may be construed by reference to associated words, is applicable to the construction of revenue laws.[20] Effect should be given, if possible to the entire statute, and part should not be permitted to perish by construction. One part should not be allowed to defeat another part, if

16 Dennison Mfg. Co. v. U. S., 72 Fed. 258; Rossman v. Hedden, 145 U. S. 561; Hedden v. Richard, 149 U. S. 346; Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

17 Pickhardt v. Merritt, 132 U. S. 252; Newman v. Arthur, 109 U. S. 132.

18 U. S. v. 1,150½ pounds of Celluloid, 82 Fed. 627; Reiche v. Smythe, 13 Wall. 162; U. S. v. Weise, 28 Fed. Cas. No. 16,659.

19 U. S. v. Mescall, 215 U. S. 26.

20 Marsching v. U. S., 113 Fed. 1006; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508, 510; Patton v. U. S., 159 U. S. 500, 509; Adams v. Bancroft, 1 Fed. Cas. No. 44; Taber v. U. S., 23 Fed. Cas. No. 13,722.

by any reasonable construction the two can stand together.[21] If the context of the statute is ambiguous, the title,[22] preamble,[23] and punctuation,[24] may be considered, but they are seldom the subject of special consideration by the legislature and are fallible and unreliable guides in ascertaining the intention of that body.[25] While the rule is that taxing statutes should be so construed as to prevent them from operating retroactively,[26] that is merely a principle of construction and the courts will not save a statute from producing a retroactive effect, if the intent that it should so operate is clear.[27]

Construction Which Will Be Constitutional. It is a well-established rule that when a statute admits of two interpretations, one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question of constitutionality, the court tends to adopt the latter interpretation.[28] The foundation of this rule, it is to be noted, is the possibility of two constructions, and the existence of grave doubt as to constitutionality. Where the doubt is not grave the courts will give the statute the most natural meaning resulting from its text, as otherwise the mere assertion that a statute is unconstitutional would tend to set aside the general rules of construction.[29]

Proceedings in Congress as Aid to Construction. Notwithstanding the well-established rule that the intent of the lawmakers is to be found in the statutes they pass, the courts, where the language of a statute is ambiguous and its meaning doubtful, should not shut their eyes to what can be learned of the history of the times and of the law, of the condition of the law at a par-

21 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961; State ex rel. Arpin v. Eberhardt, 158 Wis. 20.

22 Knowlton v. Moore, 178 U. S. 41; Smythe v. Fiske, 23 Wall. 374; Church of Holy Trinity v. U. S., 143 U. S. 457; Hedden v. Collector, 5 Wall. 107; Cornell v. Coyne, 192 U. S. 418.

23 Price v. Forrest, 173 U. S. 410, 427.

24 U. S. v. Isham, 17 Wall. 496; U. S. v. Three Railroad Cars, 28 Fed. Cas. No. 16,513; Ford v. Delta Co., 164 U. S. 662.

25 State ex rel. Arpin v. Eberhardt, 158 Wis. 20.

26 Stockdale v. Insurance Co., 20 Wall, 323; Lynch v. Turrish, 247 U. S. 221.

27 Billings v. U. S., 232 U. S. 261.

28 Stratton's Independence v. Howbert, 231 U. S. 399; Singer Mfg. Co. v. McCollock, 24 Fed. 667.

29 U. S. v. Bennett, 232 U. S. 299.

ticular time, the mischief or evil sought to be remedied, and other kindred things which would put them in the light that the lawmakers enjoyed and enable them to view the situation as it appeared to those who passed the act.[30] For such purposes, in interpreting ambiguous statutes, the formal reports of committees having in charge a pending legislative bill including the bill as introduced, changes made in the frame of the bill in the course of its passage, and statements made by the committee chairman in charge of it may, under proper qualifications, be referred to as bearing upon questions of legislative intent.[31] Courts take judicial notice of legislative journals and proceedings in Congress so far as they are admissible in aid of statutory construction.[32] But individual statements made in debate do not necessarily reflect the intent and understanding of the legislative body and are unreliable as an aid to construction, as many individual members may remain silent and may vote for a bill because in their judgment it has a wider or narrower scope than its author states.[33] Accordingly the courts may not, in interpreting a statute, recur to the motives of individual members of the legislative body nor to what they supposed the bill to mean.[34] Such individual state-

30 U. S. v. Standard Oil Co., 221 U. S. 1; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Holy Trinity Church v. U. S., 143 U. S. 457, 463; Jennison v. Kirk, 98 U. S. 453; Carbon Steel Co. v. Lewellyn, 258 Fed. 533; Northern Commercial Co. v. U. S., 217 Fed. 33; Ho Ah Kow v. Nunan, 5 Sawy. 552; Peo. v. Charles Schweinler Press, 214 N. Y. 395.

31 U. S. v. St. Paul M. & M. R. Co., 247 U. S. 310, 318; Lapina v. Williams, 232 U. S. 78; Woodward v. DeGraffenried, 238 U. S. 284; Pennsylvania R. Co. v. International Coal Min. Co., 230 U. S. 184; McLean v. U. S., 226 U. S. 374; Shallus v. U. S., 162 Fed. 653; Mosle v. Bidwell, 130 Fed. 334; Matter of Hamlin, 226 N. Y. 407, 414.

32 Connole v. Norfolk & Western Ry. Co., 216 Fed. 823; Wadsworth v. Boysen, 148 Fed. 771. In Atlantic C. L. R. Co. v. Riverside Mills, 219 U. S. 196, 200, the court in construing the Carmack amendment quotes a speech of Judge William Richardson, a congressman from Alabama, made when the amendment was reported by a conference committee. Judge Richardson was speaking for the committee of the matter which it was sought to remedy.

33 Sweetser v. Emerson, 236 Fed. 161; Johnson v. U. S., 215 Fed. 679; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Mitchell v. Great Works Milling, etc. Co., 2 Story 653; MacKenzie v. Hare, 239 U. S. 299.

34 U. S. v. Union Pacific R. R. Co., 91 U. S. 72; Omaha & C. B. Street R. Co. v. Interstate Commerce Commission, 230 U. S 324; Pennsylvania R. Co. v. International Coal Mining Co., 230 U. S. 184; Aldridge v. Williams, 3 How. 23.

ments may, however, be resorted to as a means of ascertaining the environment at the time of enactment of a particular law, that is, the history of the period when it was adopted.[35]

Effect of Rulings and Practice of Treasury Department. Great weight and due deference and respect is always given by the courts to the construction put upon a revenue statute by the Treasury Department.[36] This rule also applies to the construction of state statutes by the highest state authorities charged with the duty of administration, when the meaning of such state statutes is at issue in the Federal Courts.[37] Where the language of a statute is dubious and open to different interpretations the construction of the Treasury Department is in the highest degree persuasive, if not controlling, in its effect upon the courts, and is not to be disregarded without the most cogent reasons if it has been followed for many years without any attempt on the part of Congress to change it and where there has been a long acquiescence in it, and especially if by it the rights of parties for many years have been determined and adjusted.[38] But the construction of the Treasury Department cannot repeal a statute; it can only be resorted to in aid of interpretation, and is not applicable to what has no need of interpretation. It is therefore inadmissible and immaterial where the language of the statute is clear and precise or where it will not bear the interpretation put upon it by the Department.[39]

35 Standard Oil Company v. U. S., 221 U. S. 1; Jennison v. Kirk, 98 U. S. 453, 459; Central Building, Loan & Savings Co. v. Bowland, 216 Fed. 526. It is difficult to reconcile the authorities on the question of the admissibility of individual statements in debate in interpreting a statute. There are cases such as Roberts v. Southern Pacfic Co., 186 Fed. 934, affirmed 219 Fed. 1022, which consider such statements for more extended purposes than are permitted under the Standard Oil Co. and St. Paul M. & M. R. Co. cases and the authorities heretofore cited, but they seem contrary to the weight of authority.

36 U. S. v. Cerecedo Hermanos y Compania, 209 U. S. 338; De Ganay v. Lederer, 239 Fed. 568; affirmed 250 U. S. 376; Smythe v. Fiske, 23 Wall. 374.

37 Insurance Co. of North America v. McCoach, 218 Fed. 905 reversed 224 Fed. 657, 661, writ of certiorari granted 241 U. S. 694, reversed 244 U. S. 585; See opinion of Circuit Court of Appeals. In reversing this court the Supreme Court conceded full effect to the administrative or executive construction followed, but held that it did not answer the decisive question involved.

38 Robertson v. Downing, 127 U. S. 607; Van Dyke v. Milwaukee, (Wis.) 146 N. W. 812; see rehearing 150 N. W. 509; Galm v. U. S., 39 Ct. Cls. 55.

39 Swift Company v. U. S., 105 U. S. 691; Merritt v. Cameron, 137 U. S. 542; U. S. v. Graham, 110 U. S. 219; U. S. v. Tanner, 147 U. S. 661.

Construction by Reference to Similar Statutes. As a general rule, where a statute is of doubtful meaning and susceptible on its face of two constructions,[40] the court may look into prior acts to determine its proper construction.[41] This rule has been repeatedly applied in the construction of the Revised Statutes of the United States.[42] It is particularly applicable to revenue legislation and absolutely necessary in the case of the legislation of Congress on this subject, for without it the revenue could not be collected and inextricable embarrassments and difficulties would constantly occur.[43] The revenue laws, though made up of independent enactments, are regarded as constituting practically one system,[44] and to ascertain the legislative intent courts not only search all the provisions of the particular revenue statute in question, but look beyond those to others *in pari materia*, or of a similar purport, which compose the system.[45] Any rule of construction, separating from this revenue system, and its component numerous and diverse enactments, each new act altering it, would be unsound and unsafe.[46] When Congress re-enacts without change a statute which has previously received a construction by the Federal Supreme Court, it will be deemed to have adopted such construction,[47] and an executive or departmental construction of an earlier act will also be sanctioned by subsequent re-enactments,[48] especially where the executive or departmental con-

[40] Bate Refrigerating Co. v. Sulzberger, 157 U. S. 1.

[41] Hamilton v. Rathbone, 175 U. S. 414; Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188.

[42] Hamilton v. Rathbone, 175 U. S. 414; U. S. v. Hirsch, 100 U. S. 33; U. S. v. Bowen, 100 U. S. 508; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508.

[43] Stuart v. Maxwell, 16 How. 160.

[44] In re. Southern Pacific Co., 82 Fed. 311, affirmed 87 Fed. 863.

[45] U. S. v. Collier, 25 Fed. Cas. No. 14,833.

[46] Saxonville Mills v. Russell, 116 U. S. 21.

[47] Latimer v. U. S., 223 U. S. 501.

[48] U. S. v. Cerecedo Hermanos y Compania, 209 U. S. 338; U. S. v. Falk & Bro., 204 U. S. 143, 152; Komada v. U. S., 215 U. S. 392; Wabash Railway Co. v. Edwards, U. S. Dist. Ct.: So. Dist. N. Y.; W. T. S. 1919, ¶ 3962. In the last mentioned case the court said: "Irrespective of original considerations, it is now too late for the Department to change and by a novel ruling to alter a long settled interpretation of language taken from former Acts of Congress and thus to subject the issuance of stock under conversion privilege created prior to the passage of the present Act to an unexpected tax.

struction has been repeated and long continued[49] and where valuable property rights have been founded thereon.[50]

Similar Statutes in Other Jurisdiction. When a statute is adopted by another state or by Congress, the construction previously given to such a statute by the highest court of the state from which it is adopted presumably becomes an integral part of and is incorporated into the law so adopted.[51] This is but a narrower application of the general principle that the language of an act is used, and so is to be interpreted, according to its legal significance at the time the act is passed.[52] The rule applies only to the construction followed in the state from which the statute is originally adopted and not to that followed in the state from which the statute is immediately taken,[53] and applies also primarily to decisions in force at the time of adoption. The courts may, however, treat subsequent decisions with respect.[54] But the rule that the courts of one state will deem the interpretative decisions of another state a part of a statute adopted from that state is not an absolute one, to be followed under all circumstances. It will not be followed where the construction urged to be adopted is contrary to the obvious meaning of the statute to be construed[55] or would make the statute unconstitutional in the state of adoption.[56]

All this could have been done by Congress if language had been used specifically calling for such a result, but it cannot be accomplished by the mere use of general terms which because of the repeated rulings of the Department do not have the meaning to the business community now sought to be placed upon them. It is, of course, for the very purpose of making men's rights clearly understood, that the courts have held that long settled constructions of phrases by courts or governmental departments are to be read into statutes relating to kindred subject matters. The present case is one where this doctrine seems eminently reasonable and just.''

49 U. S. v. Baruch, 223 U. S. 191; Wabash Railway Co. v. Edwards, U. S. Dist. Ct.: So. Dist. N. Y.; W. T. S. 1919, ¶ 3962.

50 Swigart v. Baker, 229 U. S. 187.

51 Mustard v. Elwood, 223 Fed. 225; Robinson v. Belt, 187 U. S. 41; McDonald v. Hovey, 110 U. S. 619; Interstate Commerce Commission v. D. L. & W. R. Co., 220 U. S. 235.

52 Commercial Travellers Ass'n v. Rodway, 235 Fed. 370, 374.

53 Coulam v. Doull, 133 U. S. 216.

54 Cathcart v. Robinson, 5 Pet. 264.

55 Whitney v. Fox, 166 U. S. 637.

56 In re. Swearinger, 23 Fed. Cas. No. 13,683.

Strict or Liberal Construction. The authorities upon the question of whether a taxing statute should be strictly or liberally construed, or whether it should be construed according to some medium between these two extremes, are in some confusion and no broad general rule can be safely stated. Excluding the construction of tax exemptions, which will be treated hereafter, three general lines of authority can be traced. One line of cases[57] holds that, as stated by the court in a leading case:[58] "In the first place, it is, as I conceive, a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import. Revenue statutes are in no just sense either remedial laws or laws founded upon any permanent public policy, and, therefore, are not to be liberally construed." Since this decision it has been repeatedly held by the United States Supreme Court and the inferior federal courts that the provisions of a tariff act should be liberally construed in favor of the importer, and that in cases of fair doubt as to the construction of a provision in such acts the courts should resolve the doubt in favor of the importer and that in such cases the intention of Congress to impose a higher duty should be expressed in clear and unambiguous language.[59] And the

57 U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690; U. S. v. Isham, 17 Wall. 504; U. S. v. Watts, 28 Fed. Cas. No. 16,653; Equitable Trust Co. v. Seldon, 8 Fed. Cas. No. 4,507. The court said in Powers v. Barney, 5 Blatch. 202, "Duties are never imposed on the citizen upon vague or doubtful interpretations." There are early cases holding to the contrary such as U. S. v. Olney, 27 Fed. Cas. No. 15,918, where a statute imposing a license fee for lottery dealers was being construed and the court said: "A revenue law is not to be strictly construed, but rather the contrary, so as to attain the ends for which it was enacted." See Twenty-Eight Cases, 2 Ben. 63; Rankin v. Hoyt, 4 How. 327; Smythe v. Fiske, 23 Wall. 374, 380.

58 U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690.

59 Benzinger v. U. S., 192 U. S. 38; American Net & Twine Co. v. Worthington, 141 U. S. 468; Shallus v. U. S., 162 Fed. 653; U. S. v. Tiffany, 160 Fed. 408; Hayes v. U. S., 150 Fed. 63; Hempstead v. Thomas, 122 Fed. 538; U. S.

same rule has been applied in the construction of other revenue laws,[60] including the 1909 Law,[61] the 1913 Law, the 1916 Law, and the 1917 Stamp Tax Act.[62] In a comparatively late case construing the war revenue act of June 13, 1898, imposing a special excise tax on sugar the Supreme Court, adopting the language of the dissenting opinion in the Court below, held that where the construction of a tax law is doubtful, the doubt is to be resolved in favor of those upon whom the tax is sought to be laid.[63] And in a very recent case[64] arising under the 1913 Law in the Supreme Court, the rule quoted above was restated as an established rule of construction. Three recent cases in the lower federal courts have also stated generally with particular reference to the 1909 Corporation Excise Tax Law that revenue laws should be strictly construed against the government,[65] and it has been held that this rule

v. Merck & Co., 91 Fed. 639, affirmed 97 Fed. 989; Rice v. U. S., 53 Fed. 910. It has been said that the rule which gives the importer the benefit of a doubt is limited to cases where it relieves all importers of all articles whatsoever of the class concerned; that it probably has no practical use except in cases of extraordinary doubt; that it has a more appropriate application when the question is one of any tax at all; and that the federal reports are full of suits where the courts have not hesitated to perform the duty of determining mere questions of classification where it was admitted some duty was to be imposed, in favor of a higher rate, under circumstances of great difficulty. (U. S. v. Wetherell, 65 Fed. 987.)

60 Eidman v. Martinez, 184 U. S. 578; Treat v. White, 181 U. S. 264; Gill v. Bartlett, 224 Fed. 927; Rockefeller v. O'Brien, 224 Fed. 541, affirmed 239 Fed. 127; Disston v. McClain, 147 Fed. 114; Wright v. Michigan Central R. Co., 130 Fed. 843; McNally v. Field, 119 Fed. 445; Treat v. Tolman, 113 Fed. 892.

61 Parkview Building & Loan Ass'n v. Herold, 203 Fed. 876, affirmed 210 Fed. 577.

62 Haiku Sugar Co. v. Johnstone, 249 Fed. 103; U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27 (both decided since the Gould case, cited hereafter); Scott v. Western Pac. Ry. Co., 246 Fed. 545; see Miller v. Gearin, 258 Fed. 225 (decided since the Gould case) as to the 1916 law; see Wabash Railway Co. v. Edwards, U. S. Dist. Ct.; So. Dist. N. Y.; W. T. S. 1919, ¶ 3962 (decided since the Gould case). as to the 1917 Stamp Tax Act.

63 Spreckels Sugar Ref. Co. v. McClain, 192 U. S. 397.

64 Gould v. Gould, 245 U. S. 151. It is to be noted that in this case the court used almost identically the language of Judge Story in the old Wigglesworth case; also that Mr. Justice McReynolds makes no reference to the Stowell case (cited hereafter). See Crocker v. Malley, 249 U. S. 223.

65 Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918;

applies especially where they impose burdens of a special or unusual character.[66] A second line of cases holds that revenue laws are not to be strictly construed in favor of the subject and against the state, but still with reasonable fairness to the citizen. It is stated in U. S. v. Distilled Spirits:[67] "In construing a severe statute, declaring a heavy forfeiture, (and, according to one construction claimed, for small offenses,) it is just to say, that those who are called upon to conduct their business affairs in view of all its provisions, ought to be fairly apprised of its requirements, and of its penalties, of whatever kind. They are bound to know the law, but lawmakers owe to them the duty to make the law intelligible; and those whose business it is to construe or expound a law which is of doubtful or double meaning, should not incline to the harshest possible meaning, when it is obvious that those to whom it is to be applied may well have been led to trust in another which is less severe, but equally satisfying in its terms. This is not saying that laws of the kind in question are to be strictly construed in favor of the subject and against the state but, only, that they should be construed with reasonable fairness to the citizen."[68] A third line of cases announces a rule much more favorable to the government. As stated in the early cases, penalties annexed to violations of the general revenue laws do not make them penal in the sense which requires them to be construed strictly.[69] This statement was amplified and further explained in the leading case of U. S. v. Stowell,[70]

Anderson v. Morris & E. R. Co., 216 Fed. 83; Penn. Steel Co. v. N. Y. City Co., 198 Fed. 774, affirmed 231 U. S. 144.

66 Lynch v. Union Trust Co., 164 Fed. 161.

67 U. S. v. Distilled Spirits, 27 Fed. Cas. No. 15,960; 10 Blatch. 428.

68 The U. S. v. Distilled Spirits case was a penalty case arising under the Internal Revenue Laws and the rule announced in it seems to have been modified by the Stowell case (cited hereafter).

69 U. S. v. Barrels of Spirits, 2 Abb. (U. S.) 305, 314; U. S. v. Cases of Cloth, Crabbe 356; Taylor v. U. S., 3 How. 197; Cliquot's Champagne, 3 Wall. 114, 145; U. S. v. Hodson, 10 Wall. 395, 406.

70 U. S. v. Stowell, 133 U. S. 1. It is to be doubted whether in this case or the case of U. S. v. Hodson, 10 Wall. 395, 406, the Supreme Court meant to overrule Judge Story in the Wigglesworth case. In both cases the court refers as authority to the case of Taylor v. U. S., 3 How. 197, 210, which was decided by Judge Story without mentioning his immediately previous opinion in the Wigglesworth case. It seems highly improbable Judge Story meant to overrule himself in the Taylor case but rather that he had a distinction in mind between revenue laws generally and statutes to prevent fraud upon the revenue. At

which was an information on forfeiture of distilling machinery, on the theory that statutes to prevent frauds on the revenue are considered as enacted for the public good and to suppress a public wrong, and therefore, although they impose penalties or forfeitures, are not to be construed, like penal laws generally, strictly in favor of the defendant; but they are to be fairly and reasonably construed, so as to carry out the intention of the Legislature. This case has been cited and followed constantly [71] notably in a recent case [72] in the Supreme Court construing certain forfeiture provi-

the time of the Wigglesworth decision Judge Story had also decided the case of U. S. v. Breed, 24 Fed. Cas. No. 14,638 in which he said in part: "Revenue and duty acts are not in the sense of the law penal acts; and are not therefore to be construed strictly. Nor are they, on the other hand, acts in furtherance of private rights and liberty, or remedial; and therefore to be construed with extraordinary liberality. They are to be construed according to the true import and meaning of their terms; and when the legislative intention is ascertained, that, and that only, is to be our guide in interpreting them. We are not to strain them to reach cases not within their terms, even if we might conjecture, that public policy might have reached those cases; nor, on the other hand, are we to restrain their terms, so as to exclude cases clearly within them, simply because public policy might possibly dictate such an exclusion." See also Rankin v. Hoyt, 4 How. 332; Smythe v. Fiske, 23 Wall. 374, 380. In the last mentioned case the question was the amount of duty on silk ties.

71 In the following cases involving the construction of revenue laws with particular reference to penal forfeitures and criminal provisions for violations: U. S. v. Two Barrels of Whiskey, 96 Fed. 479; U. S. v. 246½ Pounds of Tobacco, 103 Fed. 791; 581 Diamonds v. U. S., 119 Fed. 556, 561; U. S. v. Cole, 134 Fed. 697; U. S. v. Gallant, 177 Fed. 281; U. S. v. Thompson, 189 Fed. 838. In the following cases with particular reference to bonds to protect the government against violations: U. S. v. Nat. Surety Co., 122 Fed. 904, 909; U. S. v. Zemel, 137 Fed. 989; U. S. v. U. S. Fidelity & G. Co., 144 Fed. 866. In the following cases as authority for the liberal construction of miscellaneous laws: Roberts v. Pacific Nav. Co., 104 Fed. 577; U. S. v. St. Louis S. W. Ry., 189 Fed. 954, 962; U. S. v. Ramsey, 197 Fed. 144, 147; U. S. v. Brown, 224 Fed. 135; Johnson v. Southern Pacific Co., 196 U. S. 1. See also Sesnon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609.

Before the Stowell decision there were cases adopting a strict construction even of statutes to prevent frauds in the revenue. See U. S. v. 84 Boxes of Sugar, 7 Pet. 453 (expressly disapproved in the Stowell case); Sixty Pipes Brandy, 10 Wheat. 424; U. S. v. A Lot Silk Umbrellas, 12 Fed. 412 (citing U. S. v. 84 Boxes Sugar); U. S. v. Ten Cases Shawls, 28 Fed. Cas. No. 16,448. One case adopting a strict construction of the statute to prevent frauds on the revenue since the Stowell case is U. S. v. 1,150½ Pounds Celluloid, 82 Fed. 634 (citing U. S. v. 84 Boxes of Sugar, supra, and not citing the Stowell case).

72 U. S. v. Graf Distilling Co., 208 U. S. 198.

sions of the internal revenue laws, and its authority has never been expressly questioned or restricted. The latest statement of the United States Supreme Court referred to above[73] makes it clear that revenue laws, as to the persons and things to be taxed will be strictly construed in the sense that their provisions will not be extended beyond the clear import of the language used or their operations enlarged so as to embrace matters not specifically pointed out, and that doubt as to such matters will be resolved more strongly against the government and in favor of the citizen. In respect to their penal provisions, however, both those working forfeitures and those imposing penalties or imprisonment, rather than in respect to the question of whom and what the statute taxes, it may still be that revenue laws will be considered as remedial in their character and so liberally construed so as to carry out the purpose of their enactment.[74]

Exemption from Taxation. This paragraph deals only with the construction of the language of a tax law which exempts. The rules of construction applicable to language which lays the tax have already been discussed.[75] The distinction between the rules of construction applicable to language laying the tax and language exempting from tax is important, for, as has been observed, in respect to the former, doubts will be resolved most strongly against the government and in favor of the citizen, while in respect to the latter, as will appear, a most strict construction in favor of the government is called for.[76] The taxing power is of vital importance and is essential to the existence of government; the whole community is interested in maintaining

[73] See Gould v. Gould, 245 U. S. 151.

[74] This distinction will not reconcile all the cases. For instance, the early cases of Smythe v. Fiske (See Note 70) and Rankin v. Hoyt, (See Note 70), the later cases of Hunter v. Corning & Co., 86 Fed. 913; Lowe v. Farbwerke-Hoechst Co., 240 Fed. 671; De Ganay v. Lederer, 239 Fed. 568 (affirmed 250 U. S. 376), clearly contemplate the application of the liberal construction with respect to subjects and objects of taxation. On the other hand, the case of U. S. v. Distilled Spirits (See Note 67) contemplates the application of the rule of liberal construction as announced in the Stowell case in a modified form; that is, neither liberally nor strictly but "with reasonable fairness to the citizen."

[75] See paragraph headed "Strict or Liberal Construction."

[76] Herold v. Parkview Building & Loan Ass'n, 210 Fed. 577.

it undiminished.[77] Exemptions from taxation are regarded as in derogation of sovereignty[78] and it is abundantly established that the taxing power should never be presumed to be relinquished unless the intention to do so be declared in clear and unambiguous terms,[79] which will admit of no other construction[80] and which are too plain to be mistaken.[81] The existence of a well founded or rational doubt is equivalent to a denial of a claim to exemption.[82] No claim can be sustained unless within the express letter or the necessary scope of the exempting clause,[83] construed *stictissimi juris;*[84] an exemption will not be inserted in a statute by construction.[85] But this salutary rule requiring a strict construction of exemptions must not be misunderstood. It is not a substitute for all other rules and does not mean that whenever a controversy is or can be raised as to the meaning of a taxing statute, such ambiguity occurs as immediately and inevitably to determine its interpretation. The proper office of the rule is to help solve ambiguities, not to compel an immediate surrender to them—to be an element in decision, and effective, perhaps, when all other tests of meaning have been employed which experience has afforded and which it is the duty of courts to consider.[86] And so courts, in construing the exempting clauses of taxing statutes, are not required to hunt for an escape from an exemption, but will, where the intent to exempt clearly appears, give effect to such intent without evasion.[87]

Rule of Construction Followed by the Treasury Department. As a general rule the construction by the Treasury Department

77 Providence Bank v. Billings, 4 Pet. 514; Christ Church v. Philadelphia County, 24 How. 300.

78 Yazoo & Miss. Vallcy R. Co. v. Thomas, 132 U. S. 174.

79 Tennessee v. Whitworth, 117 U. S. 139; Keokuk & W. R. Co. v. Missouri, 152 U. S. 301.

80 Southwestern R. R. Co. v. Wright, 116 U. S. 231.

81 Chicago, etc., R. R. Co. v. Missouri, 120 U. S. 569.

82 Phoenix Fire Ins. Co. v. Tennessee, 161 U. S. 174; Wright v. Georgia R., etc., Co., 216 U. S. 420.

83 Ford v. Delta & Pine Land Co., 164 U. S. 662.

84 Vicksburg S. & P. R. Co. v. Dennis, 116 U. S. 665.

85 Providence Bank v. Billings, 4 Pet. 514; U. S. v. Coulby, 251 Fed. 982.

86 Citizens Bank v. Parker, 192 U. S. 73.

87 Buchanan v. Knoxville & O. R. Co., 71 Fed. 324.

is such as is most favorable to the enforcement of the revenue laws and no liberal interpretation in favor of the individual is indulged in.[88] In announcing this rule the Attorney General cited the cases of Taylor v. U. S.;[89] Cliquot's Champagne,[90] U. S. v. Hodson,[91] and Smythe v. Fiske,[92] and which, as has been stated, construed both statutes to prevent frauds on the revenue and the provisions of taxing statutes laying the tax. The Attorney General does not appear to have taken account of the distinction which has been pointed out between these two kinds of provisions, so far as their construction is concerned. As a matter of practice the Treasury Department cannot, of course, assume the balanced judicial attitude of the courts in interpretation of doubtful points, as its function is to administer the law and its duty, primarily, to collect revenue. However, in some cases the Department has gone to great length in making a liberal interpretation favorable to the taxpayer.[93]

88 18 Op. Atty. Gen. 246.

89 3 How. 197, 210.

90 3 Wall. 114.

91 10 Wall. 395.

92 23 Wall. 374.

93 Compare, for instance, the Excess Profits Tax Law of 1917 (Act of October 3, 1917), with the Regulations No. 41, especially § 210 of that law with Reg. 41, Art. 62.

APPENDIX

INTEREST DEDUCTION BY CORPORATIONS UNDER REVENUE ACT OF 1916.

Under the 1916 Law, as amended, a corporation might deduct the amount of interest paid within the year on its indebtedness (except indebtedness incurred for the purchase of obligations or securities, the interest upon which was exempt from taxation as income under the law) to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding. In the case of interest paid on indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of the corporation, as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest might be deducted as a part of the expense of doing business, on an amount of such indebtedness not in excess of the actual value of such property collateral. (Revenue Act of 1916, § 12.)

Reason for the Limitation. This arbitrary limitation upon the amount of interest deductible by a corporation was a survival of a provision of the 1909 Law, which imposed an excise tax on corporations measured by the amount of income. In construing the 1909 Law the Supreme Court held that it was not in any proper sense an income tax law, but was an excise tax upon the conduct of business in a corporate capacity, the tax being measured by reference to the income. In limiting the amount of interest which a corporation could deduct under that law Congress evidently had in view the fact that some corporations carry a current indebtedness exceeding the amount of paid up capital stock and with respect to such corporations intended to limit the interest deduction to so much of the indebtedness as did not exceed the capital. It appears that Congress deemed that where the indebtedness exceeded that capital it should no longer be treated as an incident, but should be considered as a principal object of the corporate activities, and that the operations of such a corporation were conducted more for the benefit of the creditors than of the stockholders. There is no question of the power of Congress to adopt such a basis of distinction. (Anderson v. 42 Broadway Co., 239 U. S. 69, reversing 213 Fed. 777.) While the reason for such arbitrary limitation was excellent in the case of a tax such as that imposed by the 1909 Law, which could otherwise have been avoided by the conversion of capital into indebtedness, the reason applies with

much less force to the 1916 Law where the income which was not taxed to the corporation became taxable to the bondholder. To the extent, therefore, that a corporation was not permitted to deduct all of the interest paid on its indebtedness such interest was subject to tax both to the corporation and to the bondholder. This did not throw a double burden on the bondholder, but threw an extra burden on the stockholders of the corporation who were deprived of earnings to the extent that interest paid to bondholders was taxed to the corporation. The arbitrary limitation resulted in the creation of a fictitious income on which the corporation was taxed, and since such fictitious income not only was subject to a heavy income tax but entered very materially into the computation of an extraordinarily heavy excess-profits tax, the provision operated with rank injustice in the case of corporations which had an indebtedness greatly in excess of their capital stock. In fact, it seems inevitable that real estate corporations such as the Forty-two Broadway Co., which raised the question under the 1909 Law, would, under the 1916 income tax and excess profits tax laws, incur such heavy tax burdens as to place them in grave danger of insolvency.

Interest-Bearing Indebtedness. The interest-bearing indebtedness referred to in this provision of the 1916 Law did not include preferred capital stock; interest or dividends paid upon such stock was not deductible from gross income. (Revenue Act of 1916, § 12.) It did not include indebtedness secured by collateral subject to sale. Under the 1909 Law, if a corporation took title to real property subject to a mortgage but did not assume the indebtedness secured thereby, the interest could be deducted in full, as this would not be a payment by the corporation owning the property subject to such lien on its own indebtedness, because the indebtedness was not its bonded or other indebtedness, but an indebtedness created by a third party and charged as a lien upon the land acquired, subject thereto, by the purchasing corporation. (28 Op. Atty. Gen. 198.) But the 1916 Law did not permit of this construction since it provided that "payments required to be made as a condition to the continued use or possession of property," as the phrase appeared in the 1909 and 1913 Laws, must be with respect to property "to which the corporation has not taken or is not taking title or in which it has no equity." Where a corporation purchased property encumbered by a mortgage or other lien and the amount thereof was a part of and included in the purchase price, upon the payment of which the title vested absolute in the purchaser, the purchaser assumed the indebtedness on the property thus purchased and interest thereon partook in no degree of the nature of rental or franchise charges and its deduction was limited by the provisions of law. (T. D. 1865.) If a corporation had an equity in or was purchasing for its own use the real estate upon which a mortgage was a prior lien and the corporation assumed the payment of interest, the indebtedness was held to be indebtedness of the corporation and interest paid on such mortgage was deductible only within the limit fixed by the law. (Reg. 33, Art. 148.) A corporation, which did a brokerage business and bought securities for its customers, who paid only a part of the purchase price, paying interest on balances, the corporation also paying for the securities purchased only part of the purchase price and owing balances on which it paid interest, including in return of gross income the difference between the

interest received and the interest paid, was held to have made an incorrect return. The interest received by the corporation from its customers should have been included in gross income. In determining net income, interest could be deducted only to an amount not exceeding the paid-up capital stock outstanding at the close of the year. (Altheimer & Rawlings Investment Co. v. Allen, 246 Fed. 270, petition for a writ of certiorari denied November 18, 1918; Middlesex Banking Co. v. Eaton, 233 Fed. 87; T. D. 2441.)

Indebtedness Bearing Different Rates of Interest. Where a corporation had several classes of indebtedness bearing different rates of interest and the aggregate amount of indebtedness exceeded the limit allowed by law, the indebtedness bearing the highest rate might be first considered in computing the interest deduction, and the balance, if any, computed on the indebtedness bearing the next lower rate and so on until the interest on the maximum principal allowed was computed. (Reg. 33, Art. 151.)

Indebtedness Outstanding at Close of the Year. From the amount of indebtedness to be reported as indebtedness outstanding at the close of the year was required to be eliminated all indebtedness incurred in the purchase of securities the income from which was not subject to the income tax. (Reg. 33 Rev., Art. 95.) Such amount should not include indebtedness which was not bearing interest. If no indebtedness was outstanding at the close of the year, the maximum deduction allowable on account of interest paid would be measured by an amount of indebtedness not exceeding at any time within the year the entire paid up capital stock outstanding at the close of the year; that is, in such case the capital stock outstanding at the close of the year measured the highest amount of indebtedness upon which deductible interest could be computed. (T. D. 1960.) Where the indebtedness of a corporation varied from month to month so that during portions of the year the interest-bearing indebtedness outstanding was greatly in excess of the maximum principal upon which interest could be calculated and in other portions of the year less than such maximum principal, the corporation was limited to a deduction which represented the amount of interest actually paid during the year but *at all times within the limitation fixed by law*, and was not allowed to deduct the total amount of interest paid during the year, even though at the rate of interest paid (6%) such amount was less than 6% of the maximum principal. (Letter from Treasury Department dated April 29, 1918; I. T. S., 1918, ¶ 3344.)

Paid Up Capital Stock Outstanding at the Close of the Year. (See Associated Pipe Line Co. v. U. S., 258 Fed. 800.) This phrase meant the par value of shares issued as reported in Item 1 of the return from and did not include the surplus carried by the corporation. The full amount of stock represented by the par value of the shares issued was regarded as the paid up capital stock, except when such stock was assessable on account of deferred payments, or payable in installments, in which case the amount actually paid on such shares constituted the actual paid up capital stock. (T. D. 2090; Reg. 33, Art. 95.) Where the capital stock of the corporation was issued without par or nominal value, the law provided that the amount of capital stock as represented by such shares would be the amount of cash or its equivalent paid or transferred to the corporation as a consideration for such shares. If such shares were issued as a bonus in connection with shares

of preferred stock, the par value of the preferred stock would be the limit which might be claimed as paid up capital stock. If both common and preferred were issued for cash or other equivalent consideration, the amount would be the par value of the preferred stock plus the amount actually paid in on the shares issued without par value. (Letter from Treasury Department dated January 13, 1916; I. T. S. 1918, ¶ 1767.) Neither in the case of stock issued with a par value nor in the case of stock issued without par value could the amount of paid up capital stock be increased except as new capital was paid in and for which additional shares were issued. (Letter from Treasury Department dated January 13, 1916; I. T. S. 1918, ¶ 1767.)

Interest Paid by Banks on Deposits. In the case of a bank, banking association, loan or trust company, the interest paid on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such banks, banking association, loan or trust company was permitted to be deducted in full. Where a corporation, chartered as a bank, was engaged in the business of selling debenture bonds and guaranteed real estate securities, by a method by which it both paid and received interest, it was held under the 1909 Law that the interest paid out could not be deducted in full as interest paid on deposits, the transaction in no way being a banking transaction. (Middlesex Banking Co. v. Eaton, 233 Fed. 87.) Such interest could probably be deducted as inteerst paid on indebtedness secured by collateral.

Car Trust Certificates. Railroad companies were permitted to include these trust certificates in the amount of their bonded or other indebtedness reported. (Reg. 33 Rev., Art. 188.)

Interest on Indebtedness Secured by Collateral. The deduction of such interest was permitted without limit provided (a) the indebtedness was wholly secured by property collateral, tangible or intangible, (b) the collateral was the subject of sale or hypothecation in the ordinary business of the corporation as a dealer in such property or in loaning the funds thereby produced and (c) the indebtedness did not exceed the actual value of such property collateral. Such interest was deductible not as interest paid, but as an expense of doing business. The deduction was required to be stated separately in the return of annual net income and was required to be segregated from indebtedness not so secured. Failure to segregate the two forms of indebtedness resulted in a suspension or disallowance of the amount claimed. (T. D. 1993.)

Collateral the Subject of Sale. This phrase as used in the law referred to tangible or intangible property bound for the performance of certain covenants or payment of certain obligations. Real estate owned and mortgaged by corporations organized for and engaged in the business of buying, selling and dealing in real estate, warehouse receipts representing property the subject of sale in the ordinary business of the corporations owning same, and which warehouse receipts were pledged as collateral for such corporations' own debt, were examples where the interest would be deductible without limit. (T. D. 2090.) If a corporation whose ordinary business was the purchase and sale of real estate had an office building under mortgage, which office building was not subject to sale in the ordinary business of the cor-

portion, the interest paid on such mortgage might not be deducted without limit. (T. D. 2137.)

As a Dealer Only. The only corporations allowed under this proviso to deduct interest in full were those organized and operated for the purpose of buying, selling and dealing in the particular kind of property upon which the mortgage was given, and the particular property pledged for the debt upon which the interest was paid was required to be the subject of sale in the ordinary business of the corporation. (T. D. 1993.)

Ordinary Business of the Corporation. Where a corporation dealt in the property serving as collateral for the indebtedness as a matter of its ordinary business, deduction might be made in full, but where the property was held by it for the purpose of, or as an instrument in carrying on, its ordinary business such as the rights of way and other property of public utility companies, permanent office buildings and property of like character held or occupied for the particular use or purpose or the furtherance of the objects of the corporation, the property was held not to be the subject of sale in its ordinary business, but to be occupied or used as an instrument of carrying on the ordinary business for the transaction of which the corporation was organized. The fact that such property might be subject to sale under extraordinary or peculiar conditions did not qualify it as collateral. (T. D. 1993.)

ESTIMATION OF RECOVERABLE UNDERGROUND RESERVES OF OIL.

There has been a sincere effort on the part of many petroleum engineers and technologists during the past few years to devise a rational system for estimating underground reserves of oil. Much valuable work along this line has been done by various engineers and results have been given out from time to time in the publications of the technical societies and Government bureaus.

All sorts of methods and systems have been devised and most of them have merit, but the great difficulty has been to find one capable of general application.

Since the enactment of the income and war revenue tax laws producers have become much interested in this work, as they, as well as the technologists engaged in it, realize that the only channel through which might come equalization of the tax burden on them is in the proper valuation (when permissible) of oil properties, careful estimates of the underground reserves, and then the use of these two factor in the computation of proper depletion allowances.

During the autumn of the year 1918, the Internal Revenue Bureau of the Treasury Department, with the active cooperation of operators in the various districts, undertook the collection and tabulation of production data from all the fields in the United States for the purpose of making an intensive study of depletion. Records of production of thousands of properties were collected and tabulated. These were carefully gone over and studied by the most competent and experienced men in the country and the average future production curves and tables reproduced on succeeding pages of this manual are the result of their work.

This study has confirmed the belief heretofore held that it is possible to make estimates of recoverable underground reserves of oil within reasonably narrow limits. It has shown that in the making of such estimates it is simplest and safest to use some variation of production curve methods, because by the use of the productive history of a well or property as a basis for a prediction of its future, estimation is confined to the future and the personal equation thus reduced to a minimum.

Production curves and the methods for using them in making estimates of underground reserves are very fully described in section A following. It may not be out of place here, however, to state briefly that a production curve is a graphic representation of the decline in production of a well or group of wells, and that the problem presented to the estimator is the extrapolation or extension of the curve from the period of last recorded production to the economic limit for the property.

A method devised for use in the older fields uses an average decline

curve for this purpose, because a careful comparison of production records shows that while the rate of decline in production varies widely over the country as a whole, when the production records from smaller units such as pools are tabulated, the decline rates of individual wells or properties show a striking similarity, although there may be wide variations in gross production figures. In view of this fact, the data collected are grouped according to pools, and a curve plotted to show the average decline in production per well for the pool. This curve, or such portion of it as is necessary, is reproduced in the extrapolation of the decline curve for any particular property within the district, but it must be used with caution because this average decline curve is only an average, and the probabilities are that each group of wells within the district is either above or below the average. However, with care and the use of judgment, the decline curves of any particular property may be extended in this manner and the results made to show very conservatively and within reasonable limits just what the property may be expected to produce in the future.

To make the average decline curve the graphs from the production records for all the tracts in the district are assembled and assorted according to the amount of production in the last year shown and arranged in ascending order. The average interval of time required for the decline between certain arbitrarily fixed points, such as from 100 barrels to 50 barrels, or 1,000 barrels to 500 barrels, is found by ascertaining the numerical average of the time interval required for such decline on each of the properties in the district. The average declines so obtained are plotted and the resultant curve represents a true numerical average decline for every well in the district.

This curve is simply an average of averages in decline and deals with known factors only.

Its greatest fault seems to lie in the fact that in the computation of averages, only the records of those wells which are exhausted, or very nearly so, can be used in the construction of the lower end of the curve. and usually the best wells are at the same time producing at a rate which may be considerably above the economic limit of the field. Consequently, the tendency of the lower end of the curve is to show that the underground reserves are somewhat less than they will actually prove to be.

The advantage in the use of this method lies in the fact that all production records, no matter how erratic they may be, are used in its construction, without any smoothing out processes. A further advantage is that the personal equation as a factor in its construction is entirely eliminated.

This is only one of many methods devised for making an average decline curve, and in turn the average decline curve is only one way of estimating reserves by production curve methods.

For the convenience of those not accustomed to reading values from curves, tables have been prepared showing the average future production which may be expected from a well in most of the districts in the country if the production for the taxable year is known. Curves and tables are the same thing in different form.

One thing, however, must be borne in mind. These curves and tables

represent *average* conditions only in the field or pool to which they apply. Everyone knows that an average well or property is seldom encountered, so in the application of curves or tables to a specific property due allowance must be made.

A striking feature observed in connection with the study of these curves is that many decline curves of individual wells or properties which are anywhere near symmetrical, seem to assume approximately the shape of an hyperbola. Much interesting work has been done in the investigation of this feature with a view to the extrapolation of decline curves mathematically, because if a true decline curve is hyperbolic in form, when plotted on logarithmic coordinate paper it becomes a straight line, with the unknown factor in its equation, which is the slope of the line, definitely fixed in the earlier periods of production. This method of extrapolation of decline curves is worthy of consideration, but until better understood it must be used with extreme caution.

As an essential element in calculating depletion allowances in the estimation of underground reserves, the rather full discussion of the methods found best for making these estimates by investigators working with the department is given in this manual, for no single method or formula which may be generally applied has been found.

The statement has been made many times in these pages, and can not be too strongly emphasized, that the curves and tables presented herewith represent only average conditions.

In many cases they may be used safely by the operator of a single property. Where, however, holdings in any field or district are in any way extensive, it will, in most cases, be necessary for the operator to make special estimates, using any or all of the methods discussed in this manual, or it may even be found necessary to devise new combinations to fit the peculiarities of a particular tract.

In any event, care, skill, and judgment must be exercised to the utmost, and it is believed that the effort expended in this work on the part of the oil producer will be repaid many fold. Not only from a tax standpoint will this benefit come. A full knowledge of conditions such as will be brought out by a study of this problem will put the oil-producing business generally on the much firmer and safer foundation to which it is rightfully entitled.

METHODS OF ESTIMATING RECOVERABLE OIL RESERVES.

Estimation of recoverable oil is possible.—The estimation of the future production of oil wells or of the recoverable oil underlying a property in the past has been considered an almost unsolvable problem, but scientific progress has disclosed reasonably accurate solutions, especially where sufficient dependable data are brought together and arranged in an orderly manner, for then it becomes evident that there is "a system to things" and that "freaks" are comparatively few. The recovery of oil is controlled by scientific laws, and where enough facts are known these laws make themselves manifest.

During the past ten years many petroleum engineers have been working

on the problem of estimating the future production of oil wells and much progress has been made. In fact, when enough facts are available, surprisingly close estimates are usually possible, and in the future, as more and more data are compiled and analyzed, it will be possible to make much closer estimates.

Plotting Production Curves.—The production-curve method is one of the simplest and, when sufficient data are available, is, perhaps, the most accurate of all the methods for estimating the future production of oil wells. A production curve is a graphical record of the production of a well or group of wells, plotted on coordinate paper (fig. 1). It is desirable to have the production records of individual wells, but as these are kept in but a few fields, it is usually necessary to use the production record of the group of wells on a property.

To provide a basis of comparison between wells, the yearly production of a property is divided by the number of wells producing each year, thus giving the average production per well for each year. The record of an Oklahoma property that has been prepared for plotting in a production curve is given herewith.

Year	Production Barrels	Wells producing	Average per well Barrels
1906	46,860	5	9,372
1907	31,717	6	5,286
1908	15,003	6	2,501
1909	11,031	6	1,838
1910	7,047	6	1,174
1911	4,522	6	754
1912	2,462	6	410
1913	1,641	6	274
1914	1,061	6	177
1915	578	6	96
1916	218	6	36

On a sheet of coordinate paper, as in figure 1, the spaces between the light horizontal lines represent 100 barrels each and those between the heavy lines which are ten times as far apart, represent 1,000 barrels each. The heavy vertical lines represent years; thus, space between the horizontal lines represents production and between the vertical lines time. For convenience, these lines are labeled on the margins as in figures 1 and 2.

Taking the record given, the first year is 1906, during which year the average production for each well was 9,372 barrels. A point is then made on the vertical line representing the year 1906 and a distance representing 9,372 barrels above the bottom, which is 9 heavy lines and 3¾ light lines. Similarly a point is made on the line representing 1907, 5 heavy lines and 3 light lines above the bottom. And on the line representing 1908, 2 heavy and 5 light lines above the bottom show the production of 2,501 barrels for that year. The production for the rest of the years are then plotted and the points connected up by lines to make the curve as in figure 1. It

will be observed at once that the plotted record makes a fairly regular and symmetrical curve.

Manifestly, there is a certain relation between the production of the successive years that is not easily seen in the column of figures from which this curve was derived. Plotting production records in this manner has many advantages and permits the mind to grasp readily facts that otherwise would be obscured in a mass of figures.

Estimating Future Production by Production Curves.—Many thousand production or decline curves have been plotted by petroleum engineers in the manner shown, and from this wide experience it has developed that the relationships between the production of various years are such that the curves are usually notably symmetrical. Furthermore, it has been found that such curves can be extended beyond the actual period of production by continuing the curves in accordance with their symmetry and that such projections, if skillfully made, provide fairly trustworthy estimates of the future production of the well.

The estimation of the future production by the curves of past production is illustrated in figure 2. The actual record extends six years—from 1911 to 1916—and is shown by the small circles connected by the heavy lines. The dotted line shows the symmetry of this portion of the curve and beyond the year 1916, shows the extension from which estimates of future productions are made up to the year 1925. For 1917, the estimated production is 1,700 barrels, for 1918, 1,500 barrels, and for 1919, 1,300 barrels. By adding these estimates of the future years, an estimate of the total future production is obtained.

It is to be noted that production curves like figures 1 and 2 deal with actual facts and conditions on particular properties. Only the oil gauged is considered, hence all the various practical facts of field conditions are automatically taken into account. The extension of the curve estimating future production is based on the past behavior of the wells on the particular property which established the symmetry of the curve. This symmetry is not accidental but is the result of underlying natural laws governing the expulsion of the oil from the producing strata. In figure 1 it is evident that the production of the last six years could have been closely estimated from the production curve of the first five years. This method and others based on it have proved satisfactory in the appraisal of many large properties.

Obviously, manner of operation, accidents, and other factors will influence the future production just as they have the past production but experience has shown that ordinarily, these are not likely to cause wide deviation from estimates that have been carefully made. Examination of the individual production records will show whether the probability of such occurrences will make estimates unsafe.

The Appraisal-Curve Method.—The production-curve method, just discussed, necessitates a record of at least four years before any reliable estimate of the future production is possible, and usually such estimates can not be made satisfactory until the wells have produced for several years. In the most satisfactory methods for properties that have not produced this long, the future production of wells is estimated by comparison with the behavior of other wells in the same or similar districts that have produced long enough to establish

trustworthy production curves. Usually the methods of estimation are based on the average behavior of the older wells because the behavior of the new wells will approximate this average.

The appraisal curve is built up from records of individual wells or groups of wells within a certain district and is applied to wells within the same district that have not produced long enough to permit estimates of future production by extension of the production curve. It may be necessary at times to apply appraisal curves of one district to other districts for which there are not enough reliable records to make appraisal curves, and in such cases care must be taken to select curves from districts most similar.

The appraisal curve, illustrated by figure 3, is based on the relation that exists between the production of wells for their first year, and the quantities of oil they will produce ultimately. This particular figure was drawn from the production records of 209 properties in an Oklahoma field. As the average property in that field contains 10 producing wells, the figure may be said to represent about 2,000 wells. The records of each property were taken and each year's average daily production per well was computed and curves plotted from them. Only records where practically the full production had been obtained or where the future could be estimated with confidence were used. From these curves the future production of each property was estimated as explained above (Figs. 1 and 2). The future production of each property was added to past production to determine the ultimate production for each property. The next step was to plot for each property the average production per well during the first year or second year against the ultimate production of the well. Each dot, therefore, on figure 3, shows the average production per well the first year on a property and the estimated average ultimate production per well.

These dots, which represent the ultimate production of more than 200 properties, on which the wells were of many different sizes the first year, arrange themselves in a strikingly orderly manner, leaving no doubt of the existence of a definite relation between the first year's production of a well and its ultimate production. There is a considerable variation in ultimate production, however, both for wells of different and for wells of the same initial output.

These dots define the positions of the three curves drawn in to show the average and the range in ultimate production that may be expected from wells of different output in this field. It shows that two wells in this field with the same production the first year may produce different totals, yet the amount that a well of a certain output will produce will not exceed a certain maximum nor will it be less than a certain minimum. The producer, therefore, can be reasonably sure that he will not get more than a certain maximum amount of oil nor less than a certain minimum amount and is really more likely to obtain finally the amount shown by the average curve than either the maximum or minimum.

Figure 3 has been worked out on the law of averages similar to the fundamental laws underlying life insurance. Actuaries know, not by theory but from the analysis of great masses of data, the probable life of a man of any specified age, though an individual man might die the next day, or, on the other hand, might live to be a very old age. If 10,000 men are considered, however,

it is possible to predict within extremely narrow limits the age at which the average man of the group will die, and also how many men of the 10,000 will die at any specified age.

The method illustrated in figure 3 makes use of the first year's production, but the most recent year's production may be used with equal assurance, and the total production, beginning with the production of the well for the past year, can be worked out in the same manner. This fact is based on a conclusion for which there seems to be abundant statistical proof. This is as follows:

If two wells under similar conditions produce equal amounts during any given year the amounts they will produce thereafter, on the average, will be approximately equal, regardless of their relative ages. That is, if two groups of wells in the same pool have averaged, say, 5 barrels per day during the past year, they will on the average produce the same amount of oil in the future, even though the wells of one group may be only 2 years old, whereas the wells of the other group may be 5 years old. The writers were at first skeptical, but finally were forced to this conclusion because of the preponderance of evidence disclosed by the records of many thousands of wells in many different fields.

It must be carefully noted that the above statement is made for the average and applies to only one pool. The future production of any two wells may differ widely but for two large groups of wells in the same district whose current production averages the same, the statement holds true, hence if nothing is known of the past histories of two wells from which their futures may be estimated, their chances of production will be equal even though one well is much older and according to the popular idea has a more settled production.

This law of equal expectations makes possible the derivation of appraisal curves like figure 3 by other methods than the one illustrated. The curves for many of the fields were checked by two or more methods of derivation.

To estimate future production from this curve it is necessary to know the first or the most recent year's production and the number of wells producing during that year. From this average production per well is computed. Readings are then made at the intersections of the vertical lines, representing the average yearly production per well with the curves, and the horizontal lines on which these intersections lie are then followed to the right or left. This gives the maximum, average, and minimum ultimate production that may be expected per well. For example, if the wells average 30 barrels daily during any year, the 30-barrel line is followed vertically to the intersection with the minimum curve at 16,200, the average at 28,000, and the maximum at 40,500 barrels. Thus, the average 30-barrel well will produce not more than 40,500 barrels, at least 16,200 barrels, but more likely it will produce approximately 28,000 barrels. To compute the future production, the year's production—10,950 barrels—must be subtracted from these estimates. This gives the maximum, average, and minimum future estimates at 29,550, 17,050, and 5,250 barrels, respectively.

In some cases the average future production curves shown in the succeeding pages were determined in this way—that is, the past year's production was subtracted from the estimated average ultimate production, as

shown by the average ultimate production curves. These estimates of average future production were plotted and a curve drawn through the plotted points. In other cases the future-production curves were derived directly from the average-production curve. By multiplying these estimates of future production by the number of producing wells, the estimated future recovery for the developed portion of the property may be ascertained. It should be remembered, in using these future-production curves, that they represent the average and were based on all the evidence available. They do not take into consideration the increase in oil production due to the use of stimulative processes, such as compressed air, reshooting, flooding, etc.

In the appraisal curve (Fig. 3) it is to be noted that though the limits of variation are set for a well of a particular size, these limits permit a considerable variation. If nothing is known beyond the first year's production, it will be necessary to assume that the well is an average well and the average curve should be used. The probabilities are that the well will actually be nearer the average than either extreme, as shown by the dots on figure 3. If, however, the record extends back two or more years it becomes possible to tell whether the well is an average well or if it deviates from the average the direction and degree of such deviation. In other words, the longer the past history of the well, the more nearly it can be classified according to its probable future behavior. If the record is long enough, a production curve like that shown in figure 2 may be used which will in such case be preferble to these general curves. In estimating the future production, the estimates should be revised at the end of each year instead of carrying forward errors from year to year. In this way poor estimates caused by lack of data or changed conditions on the property are not perpetrated. To show how these readjustments are made, the following example is given:

A property gave an average production of 12,410 barrels, or 34 barrels per well per day, during the first year. An average 34-barrel well in this field would produce a total of 30,500 barrels ultimately, of which 12,410 barrels (34×365) were produced during the first year. This leaves a future production of 18,090 barrels per well. In order to determine the average daily production for such a well during the second year, we must assume the figure of 18,000 barrels as its ultimate production. Applying the aforesaid curve (Fig. 3), we follow the horizontal line representing this ultimate production across the chart to its intersection with the "average" curve. This gives 5,840 barrels, or 16 barrels as the first year's average daily production as a well with this ultimate production. Applying the law stated on page 866, it becomes evident that the above figure of 16 barrels is approximately equal to the daily production for its second year of a well which produced 34 barrels daily during its first year. Multiplying 16 by 365 gives a total of about 5,840 barrels, which represents the amount produced during the second year. The sum of the first and second year's production of this well is about 18,070. This amount deducted from the original ultimate production of 30,500 barrels leaves a future production of about 12,430 barrels. By repeating the same process for each successive future year until the estimated ultimate production is extinguished, the total decline of this well will be obtained.

Suppose the well actually produced 20 barrels per day, however, instead of 16 barrels, or 7,300 barrels for the year instead of 5,640. This means that the well is above the average by 30 per cent, and proper corrections are therefore made. By this means estimates may be corrected yearly and the depletion charges made more and more accurate as time goes on.

Unusual cases will have to be dealt with separately. For instance, it may not be possible to make trustworthy estimates of the future production of some wells by this method, because of the irregularity of their production. Also, those wells wherein stimulative processes are used will have to be considered separately. Wherever the wells on a property produce regularly, however, and where the property is fairly well drilled up, and the proved acreage can be easily determined, the above method should be of great value to the oil producers in making estimates of future production.

The same general procedure may be applied in making estimates of the ultimate production of undrilled but proven oil land. Proven oil land is that which has been shown by finished wells, supplemented by geologic data, to be such that other wells drilled thereon are practically certain to be commercial producers. The average future production curve may be used in making estimates of the future production of a practically drilled up nearby similar tract and the ultimate production per acre estimated. These values, with necessary modifications, on account of position on structure, sand characteristics, drainage, etc., may be applied to the undrilled tract.

Another method is to estimate the first year's production of wells to be drilled on the proved land and determine their future by use of the average future production curve. The ultimate production of the tract is the sum of the future production and of the first year's production.

Any estimate of the amount of oil that will be recovered from an undrilled but proven tract are subject to great inaccuracies. They are estimates in the truest sense of the word, but it is believed that this method is as satisfactory as any other for obtaining the probable productivity of a tract.

No attempt has been made to cover all the ramifications of the problems of estimating the future production of wells or of the underground reserves of undrilled area. The purpose of this article has been, first, to point out that if sufficient data are collected and analyzed, the law of averages discloses systematic relations between the past and future production, and, second, to show one convenient method that may be used to estimate reserves as a basis for calculating depletion deductions in a scientific manner.

ESTIMATE OF DEPRECIATION OF EQUIPMENT USED IN THE OIL AND GAS INDUSTRY.

CLASS A, NO. 1.—DRILLING EQUIPMENT.

This includes engines, boilers, rig irons, and portable derricks.

It is recommended that four years' life be allowed to equipment as a whole, depreciated at the following rate:

	Per cent.
First year	40
Second year	25
Third year	15
Fourth year	10
	90
Salvage	10
	100

Permanent derricks, rig irons, boilers, and engines left at the well are included under "Well equipment."

Drilling tools (cable and rotary), and fishing tools are included under "Tools"—Class A, No. 5.

CLASS A, NO. 2.—WELL EQUIPMENT.

As most equipment of a producing well has no separate value apart from the well, it is suggested that all wells and their equipment be depreciated at the same rate as the wells are depleted, using the same curve rate for both or where the life of the physical equipment is greater than the life of the deposit, then the depreciation rate of the physical equipment will be governed by the reasonable expectation of the life of the deposit.

When the life of the equipment is shorter than the life of the well, replaced equipment should be charged against maintenance and operation.

This method proved satisfactory in the appraisements of the Independent Oil Producers Agency of California, embracing some 180 companies, and is generally acceptable to all operators who have been consulted in the matter.

CLASS A, NO. 3.—DEHYDRATORS.

These are either of electric, pipe, or tank type. The life of the pipe and tank dehydrators is very erratic as these burn out quickly with practically no

salvage. It is recommended that this type of equipment have a straight line depreciation as follows:

	Life Years.	Depreciation per year Per cent.
Electric	5	20
Pipe	2	50
Tank	2	50

Class A, No. 4.—Tanks.

The following depreciation rate for tanks is recommended:

	Life Years.	Per cent.
Steel, 5,000 to 55,000 barrels	20	5
Steel, 2,500 to 5,000 barrels	12	8⅓
G. I., 500 to 2,500 barrels	12	8⅓
G. I., less than 500 barrels	8	12½
Wood	5	20
Movable tanks:		
G. I., 500 to 2,500 barrels	9	11⅛
G. I., less than 500 barrels	6	16⅔
G. I., water tanks, 500 to 2,500 barrels	8	12½
G. I., water tanks, less than 500 barrels	5	20

These results may be used for all classes of service—that is, oil producing, refineries, etc.

Class A, No. 5.—Tools.

This includes standard, rotary, and fishing tools. While rotary equipment may be shorter lived, it is, in general, offset by the standard tool equipment which will have a life of at least four years in many cases.

Owing to the excessive wear and tear and losses on such equipment an average life of three years is recommended, using an annual depreciation of 33⅓ per cent.

Class A, No. 6.—Transportation Equipment.

All transportation equipment, such as motor trucks, autos, wagons, horses, and harness, can be placed at a three-year life or an annual depreciation of 33⅓ per cent.

In fact, the average life of automobiles is less than three years. The percentages of cost for horses, harness, and wagons is such that the whole can be made one class with three years' life and consider no salvage.

Class A, No. 7.—Water Plants.

Considering the water well, pump, steam power, gas and oil power, electric power as a class, they may be given a useful life of approximately 10 years, which allows a straight depreciation of 10 per cent.

Class A, No. 8.—Electric Equipment.

In considering electrical equipment, one may include the separate items of generators, various size motors, transformers, wiring (both indoor and outdoor), power lines, and switchboard.

As oil-well motors are not suitable for other uses and as the class of wiring usually done on leases is not up to utility company standards, it is recommended that a combined life on electric equipment be placed at 10 years, or an annual depreciation of 10 per cent.

Class A, No. 9.—Machine Shop.

In covering machine shop there is included wood buildings, power tools, blacksmith tools, small hand tools, shafting, and shop power, which will, on an average, have a seven-year life or a depreciation rate of 14 2-7 per cent. The smaller hand tools, of course, may have a life of not more than two years, but their cost is not important and the depreciation rate is lowered by the longer life of more expensive items, such as power tools, wood buildings, shafting, and shop power.

Class A, No. 10.—Buildings.

Buildings are grouped into four general classes:

No. 1. Wood, which includes small dwellings, small outhouses, small warehouses, small power plants, and small platforms which are built on the ground. These have an average life of 10 years, which allows a depreciation rate of 10 per cent.

No. 2. Frame buildings, placed on brick or concrete foundation with siding and shingle or patent roof painted, have an average life of 15 years or a straight line depreciation of 6 2-3 per cent.

No. 3. Corrugated iron siding, renewable, has a life of six years or a depreciation rate of 16 2-3 per cent.

No. 4. Concrete, brick, and steel frame have an average life of 25 years or an annual depreciation rate of 4 per cent.

The permanent buildings may outlast the remainder of the plant; hence, no salvage value. Gulf Coast fields may claim shorter life on account of salt air conditions.

Class B.—Pipe Lines.

Pipe lines are subdivided into main line, pump stations (which include all equipment such as engines, pumps, boilers, etc.), auxiliary equipment, buildings, telephone and telegraph, and terminal facilities.

It is recommended that—

Mains 6 inches in diameter or over be based on a 20-year life or an annual depreciation of 5 per cent.

Mains under 6 inches diameter be based on a 16-year life or an annual depreciation of 6¼ per cent.

Gathering lines be based on a 10-year life or an annual depreciation of 10 per cent, with a salvage of 10 per cent.

Pump stations, including all equipment, telephone lines, and terminal facilities a life of 10 years, or an annual depreciation of 10 per cent.

These conclusions were reached after carefully considering detailed data in which it was decided that pipe lines could be grouped into the subdivisions given above.

The subject of electrolysis in pipe lines has been investigated and the losses have proved to be very small and negligible in comparison with the amounts invested, so far as making any special allowances in depreciation.

Below is given the result of a pipe line 220 miles long, having 16 stations and costing $3,906,668.

		Per cent of total	life in—	
		Cost.	Years.	Weight.
Right of way	$ 83,176	2.2	20	0.44
Ditching	497,358	12.7	[1]20	2.54
Pipe	1,323,901	33.9	20	6.78
Steel storage	426,047	10.9	20	2.18
Buildings	246,651	6.3	20	1.26
Total	$2,577,133	....	....	....
Machinery:				
Pumps	260,108	6.7	14	.94
Boilers	136,356	3.5	10	.35
Heaters	30,341	.8	10	.08
Miscellaneous (freight, etc.)	88,937	2.3	8	.18
Total	$515,742	....	....	....
Wiring	8,060	.2	10	.02
Fittings	151,725	3.9	7	.27
Commissary	270,782	6.9	10	.69
Telephone lines	85,905	2.2	10	.22
Spurs, loading racks, etc.	14,276	.4	5	.02
Sundries (tools, paints, water wells, etc., superintendence supervision)	283,045	7.2	5	.36
Total	$1,329,535	100.1	....	[2]16.33
Grand total cost	$3,906,668	....	....	....

[1] Same as pipe.

[2] Average life.

CLASS C.—TANK CARS.

This class of equipment is of very stable construction, and it would appear that the maximum 20-year life can be accorded and a 5 per cent per annum depreciation established.

CLASS C.—REFINERIES.

In order to arrive at a depreciation figure for the refinery as a whole, it is necessary to determine the relative investment in each item of equipment as compared to total investment. The various items have been grouped into classes that have about the same rate of depreciation, and the depreciation for the whole plant calculated by multiplying each item by its rate of depreciation.

Refineries were divided into two classes, skimming plants and complete refineries—that is, refineries equipped with lubricating plants (but not having cracking plants). Figures for relative investment in each class of equipment were obtained from reports on valuation of refineries and from our own estimates.

CALCULATED DEPRECIATION FOR WHOLE REFINERY.

(a) Complete Refinery

	Per cent of Total Invest-ment	Rate of Depre-ciation	Product
Equipment:	Per cent	Per cent	Per cent
Distilling equipment (stills, condensers, agitators, etc)	25	15	3.8
Power plant (boilers, engines, electrical equipment, etc.)	15	10	1.5
Buildings	10	5	.5
Storage (all kinds)	25	8	2.0
Pipes and fittings	10	12	1.2
Lubricating plant (filters, presses, chillers, grease plant, etc.)	10	10	1.0
Miscellaneous (* * * loading racks, machine shop, laboratory, etc.)	5	10	.5
Depreciation on refinery as a whole	..	..	10.5

(b) Skimming Plant

Distilling equipment	35	15	5.3
Power plant	10	10	1.0
Buildings	5	10	.5
Storage	35	8	2.8
Pipes and fittings	10	12	1.2
Miscellaneous	5	10	.5
Depreciation on refinery as a whole	..	..	11.3

Refineries can also be classed according to their location into three general classes and should be given rates of depreciation accordingly. The three classes and suggested relative depreciation are as follows:

	Useful Life Years	Deprecia-tion Rate Per cent
Well-constructed refinery plants located on the Atlantic coast or Gulf coast or at points that are assured of a supply so long as there is production east of the Rocky Mountains or from Mexico	20	5
Refinery plants of good construction located on trunk pipe lines or where a supply of crude is assured for several years	10	10
Skimming plants and small refineries of poor construction or located at points where the supply of crude is not assured for a long period of time	6	16⅔

It is suggested that the last named be depreciated according to the decline curve of the oil field supplying the oil.

The estimates of the total depreciation were based on what was considered the normal life of the plant, and no conditions that were purely local were taken into consideration. However, in making any depreciation charge the relation of the location must be taken into account. Such things as the supply of raw material, removal of market, climatic conditions, soil conditions, and the nature of the raw material are points brought out by local conditions.

Plants situated on pipe-line terminals and those on the seaboard that can be fed by tankers and pipe lines have an advantageous position. Plants in the midst of an oil field relying solely on that field for crude supply have a length of life depending on the life of the field. Plants on pipe lines controlled completely or in part by the company owning the plant are in much better shape than those dependent on a rival company for their supply of crude.

A plant is subject to the removal of its market in whole or in part when it is situated a great distance from that market and is confronted with a new plant or competitor adjacent to the market that is able to undersell the products of the distant plant. The foreign market may be completely removed through the growth of new oil fields and competitive tariff conditions.

Any abnormal rate of depreciation due to the chemical nature of the soil causing ironwork to deteriorate rapidly must be considered. Conditions of high humidity shorten the life of ironwork and brickwork.

High sulphur crudes cause stills and condensers to deteriorate rapidly. Crudes containing salt, other solid or colloidal matter and those carrying a high content of water and foreign matter cause a shorter life for general refinery equipment.

An agreement must be reached between the Treasury Department and the

refiners in cases for special districts as to just how much extra depreciation they should be allowed for a condition that is peculiar to their territory.

The total general depreciation that is allowed takes in the skimming plants and so-called complete refineries that have a lubricating plant. For plants that have a complete refinery and in addition cracking plant, certain extra depreciation charges must be allowed. In many cases the cracking plant is as much as one-tenth the total plant investment and should be given a shorter life than the average plant's life.

Class D.—Sales or Marketing Equipment.

Sales or marketing equipment is summarized in the following table:

	Life for Depreciation Years	Annual Depreciation Rate Per cent
Tankers: Where such have been bought or built during the war period, that such cost be written off to $125 per D. W. ton and at that rate........	20	5
Barges, harbor tugs, or other small floating equipment	5	20
Filling stations:		
(1) Ordinary wood or corrugated construction....	5	20
(2) Brick and concrete, or extraordinary construction	10	10
Distributing stations..................................	10	10
Tank wagons:		
Motor type	4	25
Horse type..................................	6	16 2-3
Steel barrels	7	14 2-7
Tracks and switches..................................	8	12 1-2

In considering depreciation on filling stations the factor to be given the most consideration is location. The normal life of equipment and buildings is at least 10 years, but unless the station is favorably situated it may only last 2 or 3 years.

Note.—Filling stations are divided into two classes: (a) Stations that have temporary wooden or corrugated iron buildings; and (b) stations that have buildings of brick or terra cotta, where the investment in buildings represents a large percentage of the total investment.

Distributing stations with exception of delivery equipment do not depend to such a large extent on location, and for that reason are given a longer life, although if delivery equipment is taken into consideration the depreciation rate for the whole plant would no doubt be higher than for filling stations. Delivery equipment, such as tank wagons, horses, trucks, etc., constitute a large percentage of the investment in distributing stations and are short lived; therefore, in calculating depreciation on distributing

stations the relative investment in warehouse equipment and in delivery equipment must be taken into consideration.

The rate of depreciation on tank cars is the same as that given under refinery equipment. The investment in tank cars is really a special item when considering sales equipment as a large number of marketers do not own any tank cars at all.

The same thing applies to marine equipment, since only the large companies that do an extensive export business possess marine equipment. It is believed that an average depreciation rate of 10 per cent or a life of 10 years will cover this class of equipment, since equipment such as bulkheads, docks, etc., have a life of only 4 to 6 years, while floating equipment, such as tankers, will easily last 20 years.

Class E.—Natural Gas—Utility Companies.

The drilling equipment and well equipment of natural gas companies should be depreciated at the same rate as drilling equipment and well equipment for oil wells, previously given.

The following depreciation rate is suggested for gas-pipe lines:

	Per cent.
Mains	8 1-3
Gathering lines	10
City lines	10
Compressor stations, including gas compressors, engines, boilers and equipment, should be grouped into one heading and depreciated at an annual rate of	14 2-7
Gathering stations	16 2-3
Field stations	25
Meters and regulators	20

The information at hand in which the cost of the equipment was taken into account showed that a natural gas plant could be depreciated, as a whole, at a rate of 10 per cent. It is a general consensus of opinion that the average life would not be over 10 years.

It is recommended that conditions existing on January 1, 1916, be used as a basis, and that all expenses incurred to maintain the output or carrying capacity of lines, as of that date, be treated as follows:

That intangible expenses may be charged direct to maintenance as an operating expense.

That tangible items be charged to investment or capital account and should be given a 25 per cent salvage value and the remaining 75 per cent charged off at the rate of 17½ per cent per annum for all gas properties other than those in West Virginia, Pennsylvania, and possibly Ohio, where the natural gas plants, as a whole, should be given a 15-year life, and the extensions figured on a 7-year life on a 15 per cent salvage, and the remainder charged off at the rate of 12 per cent per annum.

The above conclusions are based upon a 7-year life for gas fields in West

Virginia, Pennsylvania, and possibly certain portions of Ohio, and on a 4-year life for all other gas fields.

The shorter life for the other gas fields can be substantiated by numerous examples, such as Southern Kansas, Hogshooter, Cushing, and Pawhuska fields, all of which were large producers and were all practically exhausted within less than five years, in which the bulk was taken out within the first three years.

Class F.—Natural Gas Gasoline Plants.

Compression plants may be divided into compressors, engines, boilers, auxiliary equipment, cooling equipment, gathering and distributing lines, blending tanks, buildings, and electrical equipment.

For absorption plants, separate items of absorbers, stills, condensors, cooling equipment, auxiliary equipment, boilers, engines, electrical equipment, tanks, and loading racks may be considered.

On the whole the average life of these plants is not over five or six years.

The Fuel Administration made a survey of cost of natural gas gasoline plants. Over 800 questionnaires were sent out and of these about 400 were considered. Out of 175 plants tabulated nearly all are new plants or less than two years old, and of those operating at a loss almost all were over four years old. The returns of some 200 other plants were considered and are older plants, and were either not operating or were so defective in their detail as not to be usable for comparative purposes.

In consideration of these data and other data at hand, it is recommended that:

The original cost be placed on a 20 per cent salvage, and the remaining 80 per cent be depreciated in four years at 35, 20, 15, and 10 per cent in the respective years.

SUMMARY.

Class	No.	Reference		Useful life	Annual depreciation
		Page		Years	Per cent
A........	1	57	Drilling equipment	4	40-25-15-10
	2	57	Wells	....	....
	3	57	Dehydrators:		
			Electric	5	20
			Pipe and tanks	2	50
	4	58	Tanks:		
			Steel 5000-55000 bbl.	20	5
			2500-5000	12	8 1/3
			Galvanized-iron 500-2500	12	8 1/3
			Less than 500	8	12 1/2
			Wood	5	20
			For movable tanks:		
			Galvanized iron 500-2500	9	11 1/9
			Less than 500	6	16 2/3
			For water tanks:		
			500-2500	8	12 1/2
			Less than 500	5	20
	5	58	Tools	3	33 1/3
	6	58	Transportation equipment	3	33 1/3
	7	58	Water plants	10	10
	8	58	Electric equipment	10	10
	9	59	Machine shops	7	14 2/7
A........	10	59	Buildings:		
			Small wood	10	10
			Frame structure	15	6 2/3
			Corrugated-iron siding	6	16 2/3
			Concrete	25	4
			Brick	25	4
			Steel	25	4
B........	1	59	Pipe lines:		
			Mains over 6 inches diameter........	20	4 1/2
			Mains under 6 inches diameter........	16	5 5/8
			Gathering lines	10	9
			Less 10 per cent salvage.		
			Pump stations	10	10
C........	....	60	Tank cars	20	5
	1	60	Refineries:		
			Class 1.—Located at point assuring a long supply of crude oil; or well-constructed plants.	20	5
			Class 2.—Located at points assuring supply of crude oil for several years.	10	10
			Class 3.—Skimming plants and small refineries of poor construction, or located at points where supply of crude oil is not assured for a long period of time.	6	16 2/3
D........	1	62	Sales of marketing equipment:		
			Tankers	20	5
			Barges	5	20
			Filling stations—		
			Class A.—Ordinary wood or corrugated steel construction.	5	20
			Class B.—Brick and concrete or extraordinary construction.	10	10
			Distributing stations	10	10
			Tank wagons—		
			Motor	4	25
			Horse	6	16 2/3
			Steel barrels	7	14 2/7
			Track and switches	8	12 1/2
E........	....	63	Natural gas (utility companies):		
	1		Drilling equipment. (See A-1.)		
	2		Wells. (See A-2.)		
	3		Gas pipe lines—		
			Mains	12	8 1/3
			Gathering lines	10	10
			City lines	10	10
	4		Compressor stations	7	14 2/7
	5		Gathering stations	6	16 2/3
	6		Field stations	4	25
	7		Meters and regulators	5	20
			Considered as a whole plant........	10	20
F........	1	64	Natural gas gasoline:		
			Plant—Compression, with 20 per cent salvage value	4	35-20-15-10
			Absorption plants, with 20 per cent salvage........	4	35-20-15-10

FORM N (OIL AND GAS SECTION).

SCHEDULE 1.

FOR ASCERTAINING COST OF PROPERTY AS OF DATE OF ACQUISITION.

1. Name of property..
....
2. Location of property..
....
3. Are you sole owner of property?..............
(Yes) or (No)
4. If not sole owner, your ownership interest therein, and the name, address, and ownership interest of each of the other joint owners..........
....
5. Is property a leasehold?..............
(Yes) or (No)
6. (*a*) If so, name and address of lessor..................................
....
(*b*) Name and address of lessee.......................................
....
(*c*) Date lease effective..
(*d*) Date of expiration...
(*e*) Royalty rate...
(*f*) Bonus, either cash or property...................................
7. Date property was acquired...
8. (*a*) Manner of acquisition: (Purchase, trade, gift, etc.).................
(*b*) Amount paid in cash.......................... $................
(*c*) Amount paid in stock......................... $................
(1) Par value of stock...................... $................
(2) Actual cash value of stock.............. $................
(3) How was this cash value established?
....
(*d*) Amount paid in bonds........................ $................
(1) Par value of bonds...................... $................
(2) Actual cash value of bonds.............. $................
(3) How was this cash value established?
....
(*e*) Amount paid in other considerations.......... $................

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(1) What were the considerations?

....

(2) State actual cash value of these considerations.

....

(3) Manner of determining this cash value.

....

(4) Name and address of party establishing value.................

....

(5) Append a copy of the report of the party establishing cash value or a résumé of his report.

(*f*) Cash value of total consideration paid for property as established by you. $..............

Note.—If necessary, append a typewritten statement in order to fully answer these questions 8 (a) to 8 (f).

9. The following data regarding each separate tract are required of all taxpayers owning or operating oil and/or gas properties and/or leases.

Map.

Map showing as of date of acquisition, location of the property, property boundaries, and location of all wells and other developments in this vicinity.

This map must be on a convenient scale, preferably of not less than 1/31680 or 2 inches to the mile for developed areas, and should show the following information for each tract as of date of acquisition:

(*a*) Wells producing;
(*b*) Wells temporarily suspended;
(*c*) Wells productive but now abandoned;
(*d*) Wells completed to oil or gas sand or zone, but nonproductive;
(*e*) Wells abandoned before completion;
(*f*) Wells drilling;
(*g*) Area considered (1) producing, (2) proven, (3) highly probable, and (4) possible oil and/or gas lands, and (5) land worthless for oil and/or gas production. (Proven or proved oil or gas land is that which has been shown by finished wells supplemented by geologic data to be such that other wells drilled thereon are practically certain to be commercial producers.)

In the case of a company owning more than one tract in a single pool or field, a field map folded to letter size dimensions, say 8 by 10 inches, if not too cumbersome, may be sent, and each tract designated by a letter or some other convenient symbol.

Land data.

10. Area in acres as of date of acquisition of:
(*a*) Fully developed oil or gas territory...........................
(*b*) Proven oil or gas territory.....................................
(*c*) Highly probable oil or gas territory...........................
(*d*) Possible oil or gas territory....................................
(*e*) Territory worthless for oil or gas production...................

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*f*) Total acreage ....

11. Name and address of the party making land classification, as covered in questions 9 and 10.

....

Well data.

12. Furnish the following information as of date of acquisition:
   (*a*) Number of wells producing..................................
   (*b*) Number of wells abandoned or temporarily suspended.............
   (*c*) Number of wells drilling.....................................
   (*d*) Number of new locations yet remaining undrilled on proven territory ....

....

13. (*a*) Number of producing oil and/or gas sands proven on property......

....

   (*b*) Designation of the different sands, with the average thickness of each and the average depth from the surface to the top of each sand.

....

   (*c*) Any other information regarding conditions in wells which might be used to classify the wells in groups.

....

   (*d*) List of wells as of date of acquisition, showing the following information regarding each. (Use Table similar to 13(*e*).)
      (1) Number or letter by which each is designated.
      (2) Date of beginning drilling.
      (3) Date of beginning of production.
      (4) Date abandoned.
      (5) Initial daily production.

13(e) TABLE OF OIL WELL DATA.

(1)	(2)	(3)	(4)	(5)
Number or letter.	Date.			Initial daily production.
	Began drilling.	Began producing.	Abandoned.	
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....

Production data.

Note.—As these production data furnish the foundation for estimating depletion allowances, it is very important that they be given completely and accurately.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

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14. Submit table similar to 14(*h*) showing—

(*a*) Production of tract by calendar years, from the beginning of production to date of acquisition, with average number of wells producing each year.

(*b*) The same information for calendar years subsequent to date of acquisition.

(*c*) Amount received each year for production mentioned in (*a*) and (*b*).

(*d*) Average price per barrel received for oil, given by years since production began.

(*e*) Total production prior to date of acquisition............barrels.

(*f*) Total production subsequent to date of acquisition.........barrels.

(*g*) Total amount received for production mentioned in (*e*)and (*f*).

(e) $............ (f) $..............

14. (h) TABLE OF PRODUCTION AND VALUE OF OIL.

	Years prior to acquisition.					Year of acquisition and subsequent thereto.				
	......	......	......	......	......	......	......	......	......	......
1. Production (a) and (b). Barrels......	......	......	......	......	......	......	......	......	......	......
2. Number of wells producing (a) and (b)	......	......	......	......	......	......	......	......	......	......
3. Value of product (c)	......	......	......	......	......	......	......	......	......	......
4. Average price per barrel (d)......	......	......	......	......	......	......	......	......	......	......

(*i*) If the tract or wells have been producing for less than two years, monthly production figures must be furnished.

15. (*a*) Production of individual wells, by calendar years from beginning of production to date of acquisition, if such data are available.

(*b*) Same information for period subsequent to date of acquisition.

(*c*) If, through any cause, it is impossible to give yearly production records by individual wells, state the reasons why this information is not available.

....

Oil and Gas Reserves in Property.

16. (*a*) What was the estimated total number of units of oil and/or gas in the property on date of acquisition?......................

(*b*) How was this estimate made..................................

....

(*c*) Append a copy of the appraisal from which the estimates were derived or append a résumé of the calculations utilized in making the estimate.

(*d*) Give name and address of party making the estimate.

....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

Specific gravity.

17. (*a*) State range in specific gravity of oil recovered..................
(*b*) State average specific gravity oil delivered......................
(c) If more than one grade delivered, give percentage of each for year of acquisition...

....

Casing-head gas.

18. Submit table similar to 18 (*i*) showing—
(*a*) Quantity of casing-head gas produced by months from date of first production to date of acquisition.
(*b*) Quantity of casing-head gas produced by months for period subsequent to date of acquisition.
(*c*) Average number of wells contributing to this production each year.
(*d*) In case the gas is sold, give the amount received each month for gas mentioned in (*a*) and (*b*).
(*e*) Quantity of gasoline in gallons recovered each year from casing-head gas, mentioned in (*a*) and (*b*).
(*f*) Amount received each month for gasoline mentioned in (*e*).
(*g*) Average price per gallon received for gasoline mentioned in (*e*).
(*h*) Production of oil [1] by months for the wells from which this casing-head gas is taken. Give this information by individual wells if possible; if not, then by tracts with number of wells producing each month. When monthly records are not available give data by years.

[1] Note.—These oil production data are very important, as they are used as the basis for computing the depletion allowances in the case of gas deposits.

18 (I) TABLE OF CASING-HEAD GAS DATA ON............TRACT.

Months	Quantity casing-head gas produced (M. cu. ft.)		(c) Average number of wells producing	(d) Amount received for gas	Gasoline			(h) Production of oil
	(a) Prior to acquisition	(b) Subsequent to acquisition			(e) Quantity (Gallons)	(f) Amount received	(g) Average price per gallon	(Barrels)
....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....

Gas well data.

19. Submit table similar to 19 (*h*) giving list of gas wells as of date of acquisition, and showing—
(*a*) Number or letter by which each is designated.
(*b*) Date of beginning drilling.
(*c*) Date of beginning production.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(d) Date abandoned.
(e) Initial open flow capacity.
(f) Initial closed rock pressure.
(g) Closed rock pressure as of date of acquisition.

19 (h). TABLE OF GAS WELL DATA ON..................TRACT.

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Number or letter	Date			Initial daily open flow capacity M cubic feet	Rock pressure	
	Began drilling	Began producing	Abandoned		Initial closed pressure	Closed pressure as of date of acquisition
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....

Note.—As these production and closed pressure data furnish the foundation for estimating depletion allowances, it is very important that they be given completely and accurately.

Gas production data.

20. Submit Table similar to 20 (e), showing—
(a) Gross production (of gas) by calendar years, from beginning of production to date of acquisition, with number of wells producing each year.
(b) Same information for years subsequent to date of acquisition.
(c) Amount of money and cash value of any other consideration received each year for production mentioned in (a) and (b).
(d) Average price per thousand cubic feet of gas, by years, from beginning of production.

20 (e). TABLE OF PRODUCTION AND VALUE OF GAS.

	Prior to date of acquisition			Subsequent to date of acquisition				
Year	.....	.....	.....	.....	.....	.....	.....	.....
1. Production in 1,000 cubic feet (a) and (b)........	.....	.....	.....	.....	.....	.....	.....	.....
2. Number of wells producing (a) and (b)..........	.....	.....	.....	.....	.....	.....	.....	.....
3. Value of product (c)..........................	.....	.....	.....	.....	.....	.....	.....	.....
4. Average price per 1,000 cubic feet (d)..........	.....	.....	.....	.....	.....	.....	.....	.....

(f) Total yield from beginning production to date of acquisitien....... ....cubic feet.
(g) Total yield from beginning production to date.................. ....cubic feet.

21. Production of individual wells by calendar years for all wells to end of taxable year.

22. (a) Average rock pressure in September of each year during which production has been maintained.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*b*) Rock pressure of individual or test wells on tract. (Answers should be attached as a separate statement giving all rock pressures measured during life of the well or property. The method used in measuring pressures should be mentioned.)

Physical property.

23. Does the cost of property as given in 8 (*f*) of this schedule include any amount for plant or other physical property or for the value of the land for any other purpose than that as container of oil and gas? ....

(Yes) or (No).

24. If your answer is "yes," what amount is applicable solely:

(*a*) To the value of the oil and gas contents?...... $................

(*b*) To the surface or agricultural value of the land or its value for anything other than for its oil and gas contents?..................... $................

(*c*) To plant or other physical property?.......... $................

25. Give general inventory as of date of acquisition of the physical property mentioned in 24 (*c*), with the following information regarding each type: (Use table similar to 25 (*f*).)

(*a*) Year originally acquired.

(*b*) Original cost.

(*c*) Depreciation sustained to date of acquisition.

(*d*) Value as of date of acquisition.

(*e*) Depreciation sustained by calendar years from date of acquisition to December 31, 1918.

Note.—This classification has been adopted by the Internal Revenue Bureau and will be used hereafter in all regulations, forms, and questionnaires.

25 (*f*). INVENTORY OF PHYSICAL PROPERTY AND DEPRECIATION AS OF DATE OF ACQUISITION

Type of property	Year originally acquired (a)	Original cost (b)	Depreciation to date of acquisition (c)	Estimated cost on date of acquisition (d)*	Depreciation: Date of acquisition to end of calendar year	1914	1915	1916	1917	1918
For Oil Properties.										
Drilling equipment										
Wells										
Dehydrators:										
Electric										
Pipe and tank										
Tanks:										
Steel 5,000-55,000										
2,500-5,000										
Gathering 500-2,500										
500										
Tools										
Transportation equipment										
Water plants										
Electric equipment										
Machine shops										

* If materially different from column (b)—column (c), explain the basis of estimate.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

25 (f). INVENTORY OF PHYSICAL PROPERTY AND DEPRECIATION AS OF DATE OF ACQUISITION—Continued.

Type of property	Year originally acquired (a)	Original cost (b)	Depreciation to date of acquisition (c)	Estimated cost on date of acquisition (d)*	Depreciation: Date of acquisition to end of calendar year	Depreciation: 1914	Depreciation: 1915	Depreciation: 1916	Depreciation: 1917	Depreciation: 1918
For Oil Properties—Continued										
Buildings:										
Small wood										
Framed structure										
Corrugated iron siding										
Concrete										
Brick										
Steel										
Pipe lines:										
Mains 6 inches or over in diameter										
Mains under 6 inches in diameter										
Gathering lines, less 10 per cent salvage										
Pump stations										
Tank cars										
Refineries:										
Class 1. — Well-constructed plants located at point assuring a long supply of crude oil										
Class 2. — Well-constructed plants located at point assuring supply of crude oil for several years										
Class 3. — Skimming plants and small refineries of poor construction or located at points where supply of crude oil is not assured for a long period of time										
Sales or marketing equipment:										
Tankers										
Barges										
Filling stations—										
Class A.—Ordinary wood or corrugated steel construction										
Class B.—Brick and concrete or extraordinary construction										
Distributing stations										
Tank wagons—										
Motor										
Horse										
Steel barrels										
Wooden barrels										
Tracks and switches										
Other										
Natural Gas Properties (Utility Co.'s).										
Drilling equipment										
Wells										
Gas pipe lines:										
Mains										
Gathering lines										
Distributing lines										
Compressor stations										
Gathering stations										
Field stations										
Meters and regulators										
Considered as a whole plant										
Natural Gas Gasoline Properties										
Compression plants, with 20% salvage										
Absorption plants, with 20% salvage										

* See note, page 12.

26. In addition to the above, attach hereto any evidence, facts, statements, etc., which you desire to have considered in ascertaining the cost of the property as of date of acquisition.

SCHEDULE II.

FOR ASCERTAINING VALUE OF PROPERTY AS OF MARCH 1, 1913, OR ANY OTHER SPECIFIED DATE.

Date of valuation..................

1. Name of property ....
....
2. Location of property ....
....
3. Are you sole owner of property?...............
(Yes) or (No.)
4. If not sole owner, your ownership interest therein, and the name, address, and ownership interest of each of the other joint owners....................
....
5. Is property a leasehold?...............
(Yes) or (No.)
6. (a) If so, name and address of lessor................................
....
(b) Name and address of lessee....................................
....
(c) Date lease effective..
(d) Date of expiration...
(e) Royalty rate ....
(f) Bonus, either cash or property..................................
7. Date property was acquired.......................................
8. (a) Manner of acquisition (purchase, trade, gift, etc.).................
....
(b) Amount paid in cash.......................... $.............
(c) Amount paid in stock......................... $.............
(1) Par value of stock....................... $.............
(2) Actual cash value of stock................ $.............
(3) How was this cash value established? ....
....
(d) Amount paid in bonds......................... $.............
(1) Par value of bonds....................... $.............
(2) Actual cash value of bonds............... $.............
(3) How was this cash value established?.........................
....
(e) Amount paid in other considerations............ $.............
(1) What were these considerations?............................
....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(2) The actual cash value of these considerations .... $..............
....
(3) Manner of determining this cash value.......................
....

(*f*) Total cash value of all considerations paid for the property at time of acquisition as established by you............ $..............

Note.—If necessary, append a typewritten statement in order to fully answer these questions. 8 (a) to 8 (f).

9. The following data regarding each separate tract are required of all taxpayers owning or operating oil and/or gas properties and/or leases.

Map.

Map showing as of date of valuation, the location of the property boundaries, and location of all wells and other developments in the vicinity.

This map must be on a convenient scale, preferably of not less than 1/31680 or 2 inches to the mile for developed areas, and should show the following information for each tract as of date of acquisition:

(*a*) Wells producing.
(*b*) Wells temporarily suspended.
(*c*) Wells formerly productive but now abandoned.
(*d*) Wells completed to oil or gas sand or zone, but nonproductive.
(*e*) Wells abandoned before completion.
(*f*) Wells drilling.
(*g*) Area considered (1) producing, (2) proven, (3) highly probable, and (4) possible oil and/or gas land, and (5) land worthless for oil and/or gas production. (Proven or proved oil or gas land is that which has been shown by finished wells supplemented by geologic data to be such that other wells drilled thereon are practically certain to be commercial producers.)

In the case of a company owning more than one tract in a single pool or field, a field map folded to letter size dimensions, say 8 by 10 inches, if not too cumbersome, may be sent, and each tract designated by a letter or some other convenient symbol.

Land data.

10. Area in acres, as of date of valuation of:
(*a*) Fully developed oil or gas territory..........................
(*b*) Proven oil or gas territory..................................
(*c*) Highly probable oil or gas territory..........................
(*d*) Possible oil or gas territory..................................
(*e*) Territory worthless for oil or gas production...................
(*f*) Total acreage ....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

11. Name and address of the party making the land classification, as covered in questions 9 and 10..

....

Well data.

12. Furnish the following data regarding the wells as of date of valuation:

(*a*) Number of wells producing..................................

(*b*) Number of wells abandoned or suspended.....................

(*c*) Number of wells drilling......................................

(*d*) Number of new locations yet remaining undrilled on proven territory ....

....

13. (*a*) Number of producing oil and/or gas sands proven on property.....

....

(*b*) Designation of the different sands with the average thickness of each and average depth from surface to the top of each sand.........

....

(*c*) Any other information regarding conditions in wells which might be used to classify the wells in groups.

....

(*d*) List of oil wells as of date of valuation, showing the following information regarding each. (Use table similar to 13 (*e*).)

(1) Number or letter by which each is designated.

(2) Date of beginning drilling.

(3) Date of beginning production.

(4) Date abandoned.

(5) Initial daily production.

13 (*e*). TABLE OF WELL DATA.

(1)	(2)	(3)	(4)	(5)
	Date			
Number or letter	Began drilling	Began producing	Abandoned	Initial daily production (Barrels)
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....

Production data.

14. Submit table similar to 14 (*h*), showing—

(*a*) Production of tract by calendar years, from the beginning of production to date of valuation, with average number of wells producing each year.

(*b*) The same information for calendar years subsequent to date of valuation.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*c*) Amount received each year for production mentioned in (*a*) and (*b*).

(*d*) Average price per barrel received for oil, given by years since production began.

Also,

(*e*) Total production prior to date of valuation, ... barrels.

(*f*) Total production subsequent to date of valuation, ... bbls.

(*g*) Total amount received for production mentioned in (*e*) and (*f*).

(*e*) $...................... (*f*) $....................

14 (h). TABLE OF PRODUCTION AND VALUE OF OIL.

	Years prior to date of valuation					Years subsequent to date of valuation				
(1) Production (a) and (b) barrels	....	....	....	....	....	....	....	....	....	....
(2) Number of wells producing (a) and (b)	....	....	....	....	....	....	....	....	....	....
(3) Value of product (c)	....	....	....	....	....	....	....	....	....	....
(4) Average price per barrel (d)	....	....	....	....	....	....	....	....	....	....

(*i*) If the tract or wells have been producing for less than two years, monthly production figures must be furnished.

15. (*a*) Production of individual wells, by calendar years from beginning of production to date of valuation, if such data are available.

(*b*) Same information for period subsequent to date of valuation.

(*c*) If, through any cause, it is impossible to give yearly production records of any individual wells, state the reasons why this information is not available.

....

Note.—As these production data furnish the foundation for estimating depletion allowance, it is very important that they be given completely and accurately.

Oil and Gas Reserves in Property.

16. (*a*) What was the estimated total number of units of oil and/or gas in the property on date of valuation?..........................

(*b*) How was this estimate made?..................................

....

(*c*) Append a copy of the appraisal from which the estimates were derived, or append a résumé of the calculations utilized in making the estimate.

(*d*) Give name and address of party making the estimate.

....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

Specific Gravity.

17. (*a*) State range in specific gravity of oil recovered....................
(*b*) State average specific gravity of oil delivered....................
(*c*) If more than one grade delivered, give percentage of each for year of valuation.

....

Casing-head Gas.

18. Submit table similar to 18 (*i*), showing—
(*a*) Quantity of casing-head gas produced, by months, from date of first production to date of valuation.
(*b*) The same information for the period subsequent to date of valuation.
(*c*) Average number of wells contributing to this production each month.
(*d*) In case the gas is sold, give the amount received each month for gas mentioned in (*a*) and (*b*).
(*e*) Quantity of gasoline, in gallons, recovered each month from casing-head gas, mentioned in (*a*) and (*b*).
(*f*) Amount received each month for gasoline mentioned in (*e*).
(*g*) Average price per gallon received for gasoline mentioned in (*e*).
(*h*) Production of oil [1] by months for the wells from which this casing-head gas is taken. Give this information by individual wells if possible; if not, then by tracts with number of wells producing each month. When monthly records are not available give data by years.

18 (i). TABLE OF CASING-HEAD GAS DATA ON...........TRACT.

Month	Quantity casing-head gas produced (M cu. ft.)		(c) Average number of wells producing	(d) Amount received for gas	Gasoline			(h) production of oil (Barrels)
	(a) Prior to date of valuation	(b) Subsequent to date of valuation			(e) Quantity (Gallons)	(f) Amount received	(g) Average price per gallon	
....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....

[1] Note.—These oil production data are very important, as they are used as the basis for computing the depletion allowances in the case of gas deposits.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

Gas well data.

19. Submit table similar to 19 (*h*), giving list of gas wells as of date of valuation, and showing—
- (*a*) Number or letter by which each is designated.
- (*b*) Date of beginning drilling.
- (*c*) Date of beginning production.
- (*d*) Date of abandonment.
- (*e*) Initial open-flow capacity.
- (*f*) Initial closed rock pressure.
- (*g*) Closed rock pressure as of date of valuation.

19 (h). TABLE OF GAS WELL DATA ON——TRACT.

(a)	(b)	(c)	(d)	(e)	(f)	(g)
No. or letter	Date			Initial daily open-flow capacity (M cubic feet)	Rock pressure	
	Began drilling	Began producing	Of abandonment		Initial closed	Closed as of date of valuation
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....

Gas Production Data.

20. Submit table similar to 20 (*e*), showing—
- (*a*) Production (of gas) by calendar years from beginning of production to date of valuation, with number of wells producing each year.
- (*b*) Same information for years subsequent to date of valuation.
- (*c*) Amount of money and cash value of any other consideration received each year for production mentioned in *a* and *b*.
- (*d*) Average price per thousand cubic feet of gas, by years, from beginning of production.

20 (e). TABLE OF PRODUCTION AND VALUE OF GAS.

	Years prior to date of valuation				Years subsequent to date of valuation			
1. Production in 1,000 cubic feet (a) and (b)	....	....	....	....	....	....	....	....
2. Number of wells producing (a) and (b)	....	....	....	....	....	....	....	....
3. Value of product (c)	....	....	....	....	....	....	....	....
4. Average price per 1,000 cubic feet (d)	....	....	....	....	....	....	....	....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*f*) Total yield from beginning production to date of valuation.......
. ...cubic feet.

(*g*) Total yield from beginning production to date,............cubic feet.

21. Production of individual wells by calendar years for all wells to end of taxable year.

22. (*a*) Average rock pressure in September of each year during which production has been maintained.

(*b*) Rock pressure of individual or test wells on tract.

(Answers should be attached as a separate statement giving all rock pressures measured during life of the well or property. The method used in measuring pressures should be mentioned.)

Note.—As these production and closed pressure data furnish the foundation for estimating depletion allowances, it is very important that they be given completely and accurately.

Valuation of Property.

23. (*a*) What was the fair market value of the property as of date of valuation?...............

(*b*) How was this value ascertained?

(1) By comparison with values established by actual sales of similar properties? ....
(Yes) or (No.)

(2) By appraisal? ....
(Yes) or (No.)

(3) By assessed value? ....
(Yes) or (No.)

(4) By other method? ....
(Yes) or (No.)

24. If by comparison with values of other properties established by actual sales of these properties, give the details regarding each transaction so used and your basis of comparison...
....

25. Give the following information regarding any bona fide transactions in oil or gas properties in the region of the tract under discussion, about which you are able to obtain data.

(*a*) Property (farm............. County............. State............
Sec. .... T. .... R. ....

(*b*) Party furnishing data..

(*c*) Address ....

(*d*) Date of furnishing data..

(*e*) Source of information..

(*f*) Character of property transferred—fee title or leasehold?.............
....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*g*) What proportion of property involved in this transaction? ....

....

(*h*) Name and address of vendor and purchaser ....

....

(*i*) If a lease, name and address of lessor and lessee ....

....

(*j*) Date of transfer or lease ....
(*k*) Date of first production ....
(*l*) Total acreage of property ....
(*m*) Total proven and/or producing acreage at time of transfer ....
(*n*) Royalty rate ....
(*o*) Average gravity of the oil ....
(*p*) Number of wells on property at time of transfer ....
(*q*) Value of same as of date of transfer, $ ....
(*r*) Approximate average depth of wells ....
(*s*) Number acres per well ....
(*t*) Any other major equipment ....
(*u*) Value of same, $ ....
(*v*) Settled daily production at time of transfer or lease ....barrels
(*w*) Flush daily production at time of transfer or lease ....barrels
(*x*) Total production of property prior to transfer or lease ....barrels
(*y*) Total production to date ....barrels
(*z*) If not producing property, state approximate distance and direction to nearest producing wells ....
(*aa*) Total cash sale price or bonus or total cash value of all considerations paid for property or lease, $ ....
(*bb*) Price per barrel, settled production, $ ....

Answer this question only for those districts in which the value of properties is measured by settled daily production in barrels, such as the Mid-Continent and Appalachian Districts.

(*cc*) Price per acre, if fee purchased, $ ....
(*dd*) Ruling price per barrel or per acre of same character of property in same locality, at same time, if known, $ ....
(*ee*) Other data tending to show the cash or sale value of the property at the time of transfer ....

....

26. If by appraisal give:

(*a*) The name and address of party making the same ....

....

(*b*) His connection, if any, with you or with any of your associates or associated companies ....

....

(*c*) Date of making appraisal ....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

(*d*) Attach a copy of appraisal or, if such is not available, a résumé of method used in arriving at conclusions and a summary of calculations.

27. If by assessed valuation, fill out the following schedule:
 (*a*) Name and address of official making the assessment............
 ....
 (*b*) Did the law under which the assessment was made require an appraisal of the property—
  (1) At its actual cash value?...............................
  (2) At a portion of its cash value?.........................
  (3) If so, what portion?...................................
 (*c*) What was the total assessed valuation of the property for the year of valuation?......................................
  (1) What portion represents real property?..................
  (2) What portion represents personal property?..............
 (*d*) What portion of the assessed value of the real property represents oil and/or gas in the ground?.........................
 Estimate this as nearly as you can, if not separated by the assessor.

28. If value established by any other method than above, append a full description of the method used and a summary of calculations.

Physical Property.

29. Does the valuation as of date of valuation include any amount for plant or other physical property or for the value of the land for any other purpose than as the container of oil and/or gas?...............
(Yes) or (No).

30. If your answer is "yes," what amount is applicable solely—
 (*a*) To the value of the oil and/or gas contents?....................
 (*b*) To the surface or agricultural value of the land or its value for anything other than for its oil and/or gas contents?...........
 (*c*) To plant or other physical property?.........................

31. Give general inventory as of date of valuation of the physical property mentioned in 30 (*c*) with the following information regarding each type. (Use table similar to 31 (*f*).)
 (*a*) Year originally acquired.
 (*b*) Original cost.
 (*c*) Depreciation sustained to date of valuation.
 (*d*) Value as of date of valuation.
 (*e*) Depreciation sustained by calendar years from date of valuation to date.

Note.—This classification has been adopted by the Internal Revenue Bureau and will be used hereafter in all regulations, forms, and questionnaires.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

31 (f). INVENTORY OF PHYSICAL PROPERTY AND DEPRECIATION AS OF DATE OF VALUATION.

Type of property	(a) Year originally acquired	(b) Original cost	(c) Depreciation to date of valuation	(d) Value on date of valuation	Depreciation				
					Date of valuation or end of calendar year	1914	1915	1916	1917
For Oil Properties.									
Drilling equipment									
Wells									
Dehydrators:									
Electric									
Pipe and tank									
Tanks:									
Steel, 5,000-55,000									
2,500-5,000									
Gathering, 500-2,500									
-500									
Tools									
Transportation equipment									
Water plants									
Electric equipment									
Machine shops									
Buildings:									
Small wood									
Framed structure									
Corrugated iron siding									
Concrete									
Brick									
Steel									
Pipe lines									
Mains 6 inches in diameter or over									
Mains under 6 inches in diameter									
Gathering lines less 10 per cent salvage									
Pump stations									
Tank cars									
REFINERIES:									
Class 1. Well constructed plants located at point assuring a long supply of crude oil									
Class 2. Well constructed plants located at point assuring supply of crude oil for several years									
Class 3. Skimming plants and small refineries of poor construction, or located at points where supply of crude oil is not assured for a long period of time									
Sales or marketing equipment									
Tankers									
Barges									
Filling stations—									
Class A. Ordinary wood or corrugated steel construction									
Class B. Brick and concrete or extraordinary construction									
Distributing stations									
Tank wagons—									
Motor									
Horse									
Steel barrels									
Wooden barrels									
Tracks and switches									
Other equipment									

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

31 (f). INVENTORY OF PHYSICAL PROPERTY AND DEPRECIATION AS OF DATE OF VALUATION—Continued.

Type of property	(a) Year originally acquired	(b) Original cost	(c) Depreciation to date of valuation	(d) Value on date of valuation	Depreciation: Date of valuation of end of calendar year	1914	1915	1916	1917
For Oil Properties—Continued									
NATURAL GAS PROPERTIES (Utility Companies)									
Drilling equipment									
Wells									
Gas pipe lines:									
Mains									
Gathering lines									
Distributing lines									
Compressor stations									
Gathering stations									
Field stations									
Meters and regulators									
Considered as a whole plant									
NATURAL GAS GASOLINE PROPERTIES									
Compression plants with 20% salvage									
Absorption plants with 20% salvage									

Data indirectly relating to value as of date of valuation.

32. What was the book value of your total assets on date of valuation, exclusive of oil and/or gas in the ground? .... $..............

33. (a) State the number, the par value and the cash value of shares of your capital stock issued and outstanding on date of valuation.
   (1) Character of issue .... $..............
   (2) Number of shares ....
   (3) Par value of each share.................... $..............
   (4) Cash value of each share................... $..............
   (5) Total par value .... $..............
   (6) Total cash value .... $..............
   (b) Were any shares then outstanding not fully paid?............. If so, give details in full.......................................
....

34. On what stock exchanges were your capital stock and bonds listed on date of valuation? ....
....

35. Was your stock traded in on a "curb" market on or about date of valuation?............... If so, where?......................................
....

36. What was the quoted value of your capital stock on or about date of valuation? ....
....

37. If your stocks were not quoted on a stock exchange or curb market, give

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

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...ces in your stocks on or about date of valu-...age of them.

....

... permanent indebtedness on ...? .... $..............

...edness showing:

...scribing kind) .... $..............

...scribing kind) .... $..............

... . $..............

...describe) .... $..............

...al .... $..............

... the quoted value of your bonds, notes, and/or other cer-... of indebtedness on date of valuation? ....

...es of quotation.

....

... bonds, notes, and/or other certificates of indebtedness were ... quoted on or about date of valuation, give particulars of public ... private transactions in them on or about that date so far as ... have knowledge of such transactions.

....

... the prevailing average royalty rates stipulated in leases taken ... of date of valuation, on oil and gas lands in the districts in ... properties are located? ....

....

... so far as known to you the names of the parties to any litigation ... value of the oil and/or gas properties in the particular region of ... property under discussion or of a partnership interest or other interest ... or of stock in a corporation owning or operating the same, was in-... or about the date of valuation; also the name of the court or courts ... such litigation was conducted.

....

... Attach hereto copy of report to stockholders for each of the fiscal years ...ing and following date of valuation.

... Has the value of the oil and/or gas properties in the particular region ... the property under discussion or of any interest or stock therein been in-...ed in any partnership accounting to your knowledge on or about the date ... valuation? .... If so, append statement giving particulars.

43. (*a*) Did anyone interested in the oil and/or gas wells in the particular region of the property under discussion or as owner, operator, or member of a partnership or stockholder in a corporation owning or operating the same die on or about date of valuation? ....

(*b*) If so, give the name, the ownership interest, or the number of shares held, the approximate date of death, the residence at time of death, and the name and location of the court in which the estate was administered, and the

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

name and address of the administrator, or executor........................
....

44. If on or about the date of the valuation of the property there were any bona fide offers for its purchase, in whole or in part, or offers for the purchase of other similar properties, full details of such negotiations should be submitted. Tenders for purchase submitted through brokers or middlemen can not be considered unless supported by names of principals, together with evidence tending to show their ability and willingness to conclude the purchase in accordance with the terms of the offer made.

45. In addition to the above, attach hereto any evidence, facts, statements, etc., which you desire to have considered in the determination of the value of your property as of date of valuation.

Schedule III.

ADDITIONS TO CAPITAL ACCOUNT.

Article 223 of Regulations 45 provides that at the option of the taxpayer various items may be charged to capital account or may be deducted from gross income as an operating expense. Where deductions for depreciation or depletion have either been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return. Where a taxpayer has elected to follow one course systematically for a number of years, including 1917, he will not be permitted to amend his returns prior to 1918 for purpose of changing the method of accounting for items mentioned in this paragraph.

Has it been your practice to carry these items as capital charges or as operating expenses? ....
....

If as capital charges—

(a) Give a complete analysis of additions to capital returnable through depletion for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date............................
....

(b) Give a complete analysis of additions to capital returnable through depreciation for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date..........................
....

If these items have been deducted from gross income as operating expenses, a complete analysis of operating expense for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date, must be given ....
....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

the particulars of private transactions in your stocks on or about date of valuation, so far as you have knowledge of them.

....

38. (*a*) What was your total permanent indebtedness on date of valuation? .... $..............

(*b*) Classify this indebtedness showing:

(1) Bonds (describing kind)................ $..............

(2) Notes (describing kind)................ $..............

(3) Contracts .... $..............

(4) Other (describe) .... $..............

Total .... $..............

(*c*) What was the quoted value of your bonds, notes, and/or other certificates of indebtedness on date of valuation?..................

(*d*) Give sources of quotation.

....

(*e*) If your bonds, notes, and/or other certificates of indebtedness were not quoted on or about date of valuation, give particulars of public or private transactions in them on or about that date so far as you have knowledge of such transactions.

....

39. What were the prevailing average royalty rates stipulated in leases taken within a year of date of valuation, on oil and gas lands in the districts in which your properties are located?..

....

40. State so far as known to you the names of the parties to any litigation in which the value of the oil and/or gas properties in the particular region of the property under discussion or of a partnership interest or other interest therein, or of stock in a corporation owning or operating the same, was involved on or about the date of valuation; also the name of the court or courts in which such litigation was conducted.

....

41. Attach hereto copy of report to stockholders for each of the fiscal years preceding and following date of valuation.

42. Has the value of the oil and/or gas properties in the particular region of the property under discussion or of any interest or stock therein been involved in any partnership accounting to your knowledge on or about the date of valuation?.............. If so, append statement giving particulars.

43. (*a*) Did anyone interested in the oil and/or gas wells in the particular region of the property under discussion or as owner, operator, or member of a partnership or stockholder in a corporation owning or operating the same die on or about date of valuation?................

(*b*) If so, give the name, the ownership interest, or the number of shares held, the approximate date of death, the residence at time of death, and the name and location of the court in which the estate was administered, and the

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

name and address of the administrator, or executor........................
....

44. If on or about the date of the valuation of the property there were any bona fide offers for its purchase, in whole or in part, or offers for the purchase of other similar properties, full details of such negotiations should be submitted. Tenders for purchase submitted through brokers or middlemen can not be considered unless supported by names of principals, together with evidence tending to show their ability and willingness to conclude the purchase in accordance with the terms of the offer made.

45. In addition to the above, attach hereto any evidence, facts, statements, etc., which you desire to have considered in the determination of the value of your property as of date of valuation.

Schedule III.

ADDITIONS TO CAPITAL ACCOUNT.

Article 223 of Regulations 45 provides that at the option of the taxpayer various items may be charged to capital account or may be deducted from gross income as an operating expense. Where deductions for depreciation or depletion have either been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return. Where a taxpayer has elected to follow one course systematically for a number of years, including 1917, he will not be permitted to amend his returns prior to 1918 for purpose of changing the method of accounting for items mentioned in this paragraph.

Has it been your practice to carry these items as capital charges or as operating expenses? ....
....

If as capital charges—

(*a*) Give a complete analysis of additions to capital returnable through depletion for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date............................
....

(*b*) Give a complete analysis of additions to capital returnable through depreciation for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date..........................
....

If these items have been deducted from gross income as operating expenses, a complete analysis of operating expense for each year from date of acquisition, or from March 1, 1913, if acquired prior to that date, must be given ....
....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

SCHEDULE IV.

FOR PROOF OF DISCOVERY.

In order to prove to the satisfaction of the commissioner that a bona fide discovery of oil or gas in commercial quantities has been made, you will be required, among other things, to submit the following:

(Since the release of this form the Treasury Department has modified its regulations in respect to this subject. See p. 464.)

1. *Description of the Property.*
   - (*a*) Give a legal description of the property, including its location in section (or farm), township, range, county, and State.
   - (*b*) Are you the sole owner? .... If not, give your ownership interest therein, and the names and addresses and ownership interest of each of the other joint owners.
   - (*c*) Is the property a leasehold? .... If so, give the name and address of the lessor and the lessee..............................

....

   - (*d*) Give date lease was effective..
   - (*e*) Give date of expiration..
   - (*f*) Give royalty rate..
   - (*g*) State whether bonus was in cash or property......................

....

   - (*h*) Give any unusual terms of lease.................................

....

2. *Date of Acquisition*...
3. Give the location of the nearest producing well to the discovery well on the date discovery is claimed..

....

4. *Map of Property.*—A map of the property on a convenient scale, preferably not less than 2 inches to the mile, showing, as of the late discovery is claimed:
   - (*a*) The location of the tract and of the discovery well in question and in addition the development in the field for a radius of approximately 3 miles from the well in question;
   - (*b*) The producing, suspended or abandoned, and drilling wells; and
   - (*c*) The areas which are considered producing, proven, highly probable, possible, or worthless oil and gas land.
5. A certified copy of the log of the discovery well, showing:
   - (*a*) The location.
   - (*b*) Date drilling began, date of completion, and the beginning of production.
   - (*c*) The formations penetrated; the oil, gas and water sands penetrated; the casing record, including the record of perforation and any other information tending to show the condition of the well and the location of the sand or sands from which the oil or gas came on the date the discovery was claimed.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

6. The logs of enough other wells drilled prior to the date of completion of the discovery in the vicinity of the discovery well to convince the commissioner that the pool, field, structure, sand, or zone, discovery of which is claimed, was not known prior to the so-called discovery.

7. A sworn record clearly proving the commercial productivity of the discovery well. This record must cover a period of not less than 30 days and, if possible, should include the production of the entire period by months from the date of discovery to the end of the first year.

8. In the case of the discovery being made within 3 miles of producing wells, the production data from enough wells within this area to indicate the average productivity of the wells drilled prior to the date of drilling the discovery well.

9. The specific gravity of:

(*a*) The oil recovered from the discovery well........................

(*b*) Oil produced by wells nearest to the discovery well which were producing at the time of the drilling of the discovery well..........

....

10. Give the following information regarding each well drilled on the same tract or lease as the discovery well prior to and subsequent to the date of the discovery:

(*a*) Number of well...

(*b*) Date of beginning drilling...................................

(*c*) Date of beginning production..............................

(*d*) Date abandoned ....

(*e*) Initial daily production......................................

And in the case of wells drilled prior to the date of discovery:.....

(*f*) Copy of the log of the well, including the formations penetrated....

(*g*) The casing record and any other information tending to show the condition of the well on the date discovery was claimed in the discovery well ....

....

11. Give any other evidence, facts, statements, etc., which you desire to have considered, proving that the so-called discovery is bona fide and that the pool, field, structure, sand, or zone, discovery of which is claimed, was not known prior to the date of discovery.

Schedule V.

FOR DEPLETION.

Note.—This schedule is not to be filled out until the questions in Schedule I and/or II have been answered and the computations called for therein made.

With respect to each property producing oil and/or gas during the taxable year, income from which is covered by the return under consideration, give the following facts:

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

1. Description of property ....

....

2. Value (exclusive of physical properties) as of March 1, 1913, or, if discovery is claimed subsequent to that date, value as of date of discovery or within thirty days thereafter. (See Schedule II, question 23 (*a*).) ....
.... $................

3. Cost (exclusive of physical property, or the value of the land for anything other than its oil and gas contents) if acquired subsequent to March 1, 1913, and no discovery is claimed. (See Schedule I, question 24 (*a*).)

4. Estimated quantity of oil and/or gas in the ground:

(*a*) As of March 1, 1913. (See Schedule II, question 16 (*a*).) ....
....

(*b*) As of date of discovery or thirty days thereafter. (See Schedule II, question 16 (*a*).) ....

(*c*) As of date of acquisition. (See Schedule I, question 16 (*a*).) ....
....

5. Fill out the following table:

Data desired.	Mar. 1, 1913	1914	1915	1916	1917	1918	Total
(a) Capital account returnable through depletion, at beginning of year	....	....	....	....	....	....	....
(b) Capital returnable through depletion added during year	....	....	....	....	....	....	....
(c) Total capital account against which depletion for year is chargeable [(a) plus (b)]	....	....	....	....	....	....	....
(d) Estimated quantity of recoverable crude oil in ground at beginning of year in barrels of 42 gallons	....	....	....	....	....	....	....
(e) Production for year in barrels of 42 gallons	....	....	....	....	....	....	....
(f) Unit cost of recoverable product [(c) divided by (d)]	....	....	....	....	....	....	....
(g) Amount of depletion sustained during year [(f) multiplied by (e)]	....	....	....	....	....	....	....

Note.—If the "unit cost" method of computing depletion was not used in computing the depletion allowance for the various years mentioned in the above table, state what method was used in calculating the depletion and give a complete résumé of the calculations so that the commissioner may arrive at an intelligent conclusion as to whether or not the depletion allowance claimed for year was equitable and based on the actual production of that year.

SCHEDULE VI.

FOR DEPRECIATION.

Note.—This schedule is not to be filled out until the questions in Schedules I and/or II have been answered and the computations called for therein made.

With respect to each tract on which there is physical property, mentioned in the return under consideration, give the following facts:

1. Description of property ....
....

2. Value of physical properties as of March 1, 1913, or their cost, if acquired subsequent to that date. (See Schedule II, 30 (*c*), or Schedule I, 24 (*c*).) ....

3. Fill out the following table or one similar:

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

Data desired.	1913	1914	1915	1916	1917	Total.
(a) Capital account returnable through depreciation at beginning of year	....	....	....	....	....	....
(b) Capital returnable through depreciation added during year	....	....	....	....	....	....
(c) Total capital account against which depreciation for year is chargeable (a plus b)	....	....	....	....	....	....
(d) Amount of depreciation sustained during year	....	....	....	....	....	....

SCHEDULE VII.

FOR THE PROOF OF BONA FIDE SALE.

In proving that a bona fide sale has actually been consummated, you will be required to furnish the following information:

1. Description of the property.
   (*a*) Give a legal description of the property, including its location in section (or farm), township, range, county, and State............
   ....
   (*b*) State whether or not you are the sole owner?.......... If not, your ownership interest therein, and the names and addresses and the ownership interest of each of the other joint owners..............
   ....
   (*c*) Is the property a leasehold?.......... If so, give the name and address of the lessor and the lessee............................
   ....
   (*d*) Give date lease was effective?..................................
   (*e*) Give date of expiration?......................................
   (*f*) Give royalty rate?...
   (*g*) State whether bonus was in cash or property.....................
   ....
   (*h*) Give any unusual terms of lease...............................
   ....
2. Date of disposal of property..
3. State manner of disposal of property, whether by sale, trade, gift, etc. ....
4. (*a*) Give the amount received in cash, stock, bonds, and other considerations ....
   ....
   (*b*) Give the par value of the stock, bonds, or other obligations.........
   (*c*) Give the actual cash value of the stock, bonds, or other considerations on the date of disposal of the property....................
   (*d*) State how these cash values were established......................
   ....
   (*e*) Give the name and address of the party determining or establishing these values..
   ....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

1. Description of property..

....

2. Value (exclusive of physical properties) as of March 1, 1913, or, if discovery is claimed subsequent to that date, value as of date of discovery or within thirty days thereafter. (See Schedule II, question 23 (*a*).)............

.... $.................

3. Cost (exclusive of physical property, or the value of the land for anything other than its oil and gas contents) if acquired subsequent to March 1, 1913, and no discovery is claimed. (See Schedule I, question 24 (*a*).)

4. Estimated quantity of oil and/or gas in the ground:

(*a*) As of March 1, 1913. (See Schedule II, question 16 (*a*).)..........

....

(*b*) As of date of discovery or thirty days thereafter. (See Schedule II, question 16 (*a*).) ....

(*c*) As of date of acquisition. (See Schedule I, question 16 (*a*).).......

....

5. Fill out the following table:

Data desired.	Mar. 1, 1913	1914	1915	1916	1917	1918	Total.
(a) Capital account returnable through depletion, at beginning of year..................	....	....	....	....	....	....	....
(b) Capital returnable through depletion added during year	....	....	....	....	....	....	....
(c) Total capital account against which depletion for year is chargeable [(a) plus (b)]	....	....	....	....	....	....	....
(d) Estimated quantity of recoverable crude oil in ground at beginning of year in barrels of 42 gallons	....	....	....	....	....	....	....
(e) Production for year in barrels of 42 gallons	....	....	....	....	....	....	....
(f) Unit cost of recoverable product [(c) divided by (d)]	....	....	....	....	....	....	....
(g) Amount of depletion sustained during year [(f) multiplied by (e)]	....	....	....	....	....	....	....

Note.—If the "unit cost" method of computing depletion was not used in computing the depletion allowance for the various years mentioned in the above table, state what method was used in calculating the depletion and give a complete résumé of the calculations so that the commissioner may arrive at an intelligent conclusion as to whether or not the depletion allowance claimed for year was equitable and based on the actual production of that year.

Schedule VI.

FOR DEPRECIATION.

Note.—This schedule is not to be filled out until the questions in Schedules I and/or II have been answered and the computations called for therein made.

With respect to each tract on which there is physical property, mentioned in the return under consideration, give the following facts:

1. Description of property..

....

2. Value of physical properties as of March 1, 1913, or their cost, if acquired subsequent to that date. (See Schedule II, 30 (*c*), or Schedule I, 24 (*c*).)....

3. Fill out the following table or one similar:

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

7. Amount received in other considerations:
(a) What were these considerations? ....
....
(b) Actual cash value of these considerations........ $................
(c) Manner of determining this cash value............................
....
(d) Name and address of the party determining this value.............
....
8. Cash value of all considerations received for property........ $.........
9. Value of property as of March 1, 1913, or its cost if acquired subsequent to that date. (See Schedule I, question 8 (f), or Schedule II, question 23)... .... $................
10. Total of all additions to capital returnable through depletion added subsequent to March 1, 1913, or subsequent to date of acquisition if property acquired subsequent to March 1, 1913. (See Schedule V, question 5 (b).)...... .... $................
11. Total of all additions to capital returnable through depreciation added subsequent to March 1, 1913, or subsequent to date of acquisition if acquired subsequent to March 1, 1913. (See Schedule VI, question 3 (b).)............ .... $................
12. Gross value of property as of date of disposition. (Total 9, 10, and 11.) .... $................
13. Total depletion sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property. (See Schedule V, question 5 (g).)......... $.........
14. Total depreciation sustained during period from March 1, 1913, to date of disposition of property. (See Schedule VI, question 3 (d).).............. .... $................
15. Net value of property as of date of disposition of property (12 less the sum of 13 and 14).................................... $................
16. Profit or loss sustained from disposition of property (difference between 8 and 15).................................... $................

Schedule IX.

FOR PROVING THAT THE PRINCIPAL VALUE HAS BEEN DEMONSTRATED BY PROSPECTING OR EXPLORATION AND DISCOVERY WORK DONE BY THE TAXPAYERS.

In the case of the bona fide sale of oil or gas properties, or any interest therein, in order to take advantage of the clause in Section 211-b of the Revenue Act of 1918, which limits the portion of the tax imposed by said Act attributable to such sale to a sum not to exceed twenty percentum of the selling price of such property or interest, you will be required to furnish the following, under oath, in order to satisfy the Commissioner that the principal

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

5. Give the total cash value of the consideration received by you in return for the property...

....

6. (a) Give the name and address of the party to whom the property was transferred ....

....

(b) Give the connection, if any, between the party or parties disposing of the property and the party making the purchase or with any of his associates or associated companies..........................

....

7. In disposing of the property, was the price at which the property was sold fixed for the purpose of a bona fide purchase and sale by which the property passed to an owner in fact as well as in form different from the vendor? No fictitious nor inflated sale price will be permitted to form the basis for the price established for this schedule.

8. Give any evidence, facts, statements, etc., which you desire to have considered as proof in the determination of the bona fide character of the transaction.

Schedule VIII.

FOR COMPUTATION OF PROFIT OR LOSS FROM SALE OF CAPITAL ASSETS.

Note.—This page is not to be filled out until the questions in the schedules called for herein have been answered and the computations called for therein made.

With respect to each property disposed of during the year you are requested to furnish the following information:

1. Description of property...

....

2. Date of disposal of property.......................................
3. Manner of disposal of the property (sale, trade, gift, etc.)..............

....

4. Amount received in cash............................ $................
5. Amount received in stock:
   (a) Par value of stock.............................. $................
   (b) Actual cash value of stock.................... $................
   (c) How was this cash value established?...........................

....

6. Amount received in bonds:
   (a) Par value of bonds.............................. $................
   (b) Actual cash value of bonds.................... $................
   (c) How was this cash value established?...........................

....

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

7. Amount received in other considerations:
(*a*) What were these considerations? ....
....
(*b*) Actual cash value of these considerations........ $...............
(*c*) Manner of determining this cash value...........................
....
(*d*) Name and address of the party determining this value.............
....
8. Cash value of all considerations received for property........ $.........
9. Value of property as of March 1, 1913, or its cost if acquired subsequent to that date. (See Schedule I, question 8 (*f*), or Schedule II, question 23)... .... $...............
10. Total of all additions to capital returnable through depletion added subsequent to March 1, 1913, or subsequent to date of acquisition if property acquired subsequent to March 1, 1913. (See Schedule V, question 5 (*b*).)...... .... $...............
11. Total of all additions to capital returnable through depreciation added subsequent to March 1, 1913, or subsequent to date of acquisition if acquired subsequent to March 1, 1913. (See Schedule VI, question 3 (*b*).)............ .... $...............
12. Gross value of property as of date of disposition. (Total 9, 10, and 11.) .... $...............
13. Total depletion sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property. (See Schedule V, question 5 (*g*).)......... $.........
14. Total depreciation sustained during period from March 1, 1913, to date of disposition of property. (See Schedule VI, question 3 (*d*).)............. .... $...............
15. Net value of property as of date of disposition of property (12 less the sum of 13 and 14)................................ $...............
16. Profit or loss sustained from disposition of property (difference between 8 and 15).................................. $...............

Schedule IX.

FOR PROVING THAT THE PRINCIPAL VALUE HAS BEEN DEMONSTRATED BY PROSPECTING OR EXPLORATION AND DISCOVERY WORK DONE BY THE TAXPAYERS.

In the case of the bona fide sale of oil or gas properties, or any interest therein, in order to take advantage of the clause in Section 211-b of the Revenue Act of 1918, which limits the portion of the tax imposed by said Act attributable to such sale to a sum not to exceed twenty percentum of the selling price of such property or interest, you will be required to furnish the following, under oath, in order to satisfy the Commissioner that the principal

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

value of the property has ben demonstrated by prospecting or exploration and discovery work done by the taxpayer.

1. *Description of the property.*

(*a*) Give a legal description of the property, including its location in section (or farm), township, range, county, and State.......................
....

(*b*) Are you the sole owner?............ If not, give your ownership interest therein, and the names and addresses and ownership interest of each of the other joint owners..........................
....

(*c*) Is the property a leasehold?............ If so, give the name and address of the lessor and the lessee............................
....

(*d*) Give date lease was effective...

(*e*) Give date of expiration...

(*f*) Give royalty rate...

(*g*) State whether bonus was in cash or property......................
.... $.................

(*h*) Give any unusual terms of lease...................................
....

2. The value of the property immediately prior to the date of beginning prospecting or exploration and discovery work done by you leading to the discovery claimed. (This value must be established through filling out Schedule II, as of the specified date immediately prior to the discovery.)

3. The proof that a discovery has been made. (To furnish this proof you will be required to fill out Schedule III.)

4. The value of the property at any specified date within a reasonable time after the discovery was made. (This value may be established by filling out Schedule II for the specified date.)

5. Give any evidence, facts, statements, etc., which you desire to have considered as showing that the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by you.

Note.—Attach separate statement for each tract, entering your totals only on this sheet.

FORM A (MINES AND MINERALS SECTION).
(Revised May, 1919.)

SCHEDULE 1.

FOR ASCERTAINING COST OF PROPERTY AS OF DATE OF ACQUISITION.

1. Name of property..
....
2. Location of property..
....
3. Are you sole owner of property?............
(Yes) or (No).
4. If not sole owner, state your ownership interest therein, and the name, address, and ownership interest of each of the other joint owners......
....
5. Is property a leasehold?.............
(Yes) or (No).
6. If so, furnish the following information:
(a) Name and address of lessor......................................
....
(b) Name and address of lessee......................................
....
(c) Date lease effective..
(d) Date of expiration of lease......................................
(e) Royalty rate ....
(f) Bonus, either cash or property..................................
7. Date property was acquired..
8. (a) Manner of acquisition: (Purchase, trade, gift, etc.)................
(b) Amount paid in cash.......................... $................
(c) Amount paid in stock........................ $................
(1) Par value of stock........................ $................
(2) Actual cash value of stock.................. $................
(3) How was this cash value established?
....
(d) Amount paid in bonds........................ $................
(1) Par value of bonds........................ $................
(2) Actual cash value of bonds.................. $................
(3) How was this cash value estabished?
....
(e) Amount paid in other considerations............ $................
(1) What were the considerations?
....

(2) State the actual cash value of these considerations

....

(3) How was this cash value established?

....

(*f*) Give name and address of party establishing cash values..........

....

Append a copy of the report of the party establishing cash values or a résumé of his report.

(*g*) Cash value of total consideration paid for property as established by you. $............

NOTE—If necessary, append a typewritten statement in order to fully answer these questions 8 (*a*) to 8 (*g*).

9. The following data regarding each separate tract are required of all taxpayers owning or operating mining properties or leases.

Maps.

General map showing as of date of acquisition, acreage, location of property, mines, shafts, tunnels, etc., and the location of lodes, veins, beds, or other deposits in the property in question and adjacent properties. Indicate which were being operated.

Mine map showing all workings, with ore or other mineral blocked out, probable ore and possible ore, giving general outlines of the deposit (s) of value.

10. Furnish the following information as of date of acquisition:

(*a*) Average daily output of property..............................

(*b*) Number of producing veins, seams, beds, deposits, etc., proven on property, giving designations of each..........................

....

11. Give a general outline of the history of the property to date of acquisition

....

12. Mineral reserves in property as at date of acquisition. Amount (in customary units) of—

(*a*) Fully developed ore or other valuable mineral.....................

....

(*b*) Probable or partly developed ore or other valuable mineral.........

....

(*c*) Possible ore or other valuable mineral..........................

....

(*d*) Give name and address of party making above classification.......

....

Append a copy of the appraisal from which the estimates were derived, or append a résumé of the calculations utilized in making the estimate.

Physical property

13. Does the cost of property as given in 8 (*g*) of this schedule include any amount for plant or other physical property or for the value of the land for any other purpose than that as the container of mineral deposits?...........

(Yes) or (No)

14. If your answer is "yes" what amount is applicable solely:

(*a*) To the value of the mineral contents.................$..........

(*b*) To the value of mill and smelter sites, rights of way, etc..........
.... $................

(*c*) To the surface or agricultural value of the land or its value for anything other than its mineral contents or for mining and milling operations
.... $............

(*d*) To plant or other physical property..................$..........

15. Give general inventory as of date of acquisition of the property mentioned in 14 (*d*), with the following information regarding each type (use table similar to 15 (*f*).):

(*a*) Year originally acquired by vendor.

(*b*) Original cost to vendor.

(*c*) Depreciation sustained to date of acquisition.

(*d*) Value as of date of acquisition.

(*e*) Depreciation sustained by calendar years from date of acquisition to December 31, 1918, as shown by your books.

15 (f.) INVENTORY OF PHYSICAL PROPERTY AND DEPRECIATION AS OF DATE OF ACQUISITION.

Type of property.	Year originally acquired (a).	Original cost (b).	Depreciation to date of acquisition (c).	Value as of date of acquisition (d).	Depreciation. (Use a column for each year from date of acquisition to Dec. 31, 1918.)					
					Year	Year	Year	Year	Year	Year ......

16. In addition to the above, attach hereto any evidence, facts, statements, etc., which you desire to have considered in ascertaining the cost of the property as of date of acquisition.

SCHEDULE II.

FOR ASCERTAINING VALUE OF PROPERTY AS OF MARCH 1, 1913, OR ANY OTHER SPECIFIED DATE.

Date of valuation*........................

* Date of valuation is the date as of which the value is set up.

1. Name of property ....
....

2. Location of property ....
....

3. Are you sole owner of property?............
(Yes) or (No).

4. If not sole owner, state your ownership interest therein, and the name,

address, and ownership interest of each of the other joint owners............

....

5. Is property leasehold? ....
(Yes) or (No).

6. If so, furnish the following information:

(a) Name and address of lessor..

....

(b) Name and address of lessee..

....

(c) Date lease effective..

(d) Date of expiration of lease..

(e) Royalty rate ....

(f) Bonus, either cash or property.......................................

7. Date property was acquired ....

8. (a) Manner of acquisition (purchase, trade, gift, etc.)....................

....

(b) Amount paid in cash .... $...........

(c) Amount paid in stock.......................... $...........

(1) Par value of stock .... $...........

(2) Actual cash value of stock.................. $...........

(3) How was this cash value established?.......................

....

(d) Amount paid in bonds.......................... $...........

(1) Par value of bonds .... $...........

(2) Actual cash value of bonds .... $...........

(3) How was this cash value established?.......................

....

(e) Amount paid in other considerations............... $...........

(1) What were these considerations? ....

....

(2) State the actual cash value of these considerations $...........

(3) Describe fully the manner of determining this cash value.......

....

(f) Give name and address of party establishing Cash values..........

....

Append a copy of the report of the party establishing cash values or a résumé of his report.

(g) Total cash value of all considerations paid for the property at time of acquisition as established by you.............. $...........

Note.—If necessary, append a typewritten statement in order to fully answer these question. 8 (a) to 8 (g).

9. The following data regarding each separate tract are required of all taxpayers owning or operating mining properties or leases.

Maps.

General map showing as of date of valuation, location of property, mines, drafts, tunnels, etc., and the location of lodes, veins, beds, or other deposits in the property in question and adjacent properties. Indicate which were being operated.

Mine map showing all workings, with ore or other mineral blocked out, probable ore and possible ore, giving general outlines of the deposit(s) of value.

10. Furnish the following information as of date of valuation:

(a) Average daily output of property..............................

(b) Number of producing veins, seams, beds, deposits, etc., proven on property, giving designations of each........................

....

11. Give a general outline of the history of the property to date of valuation

....

....

12. Mineral reserves in property as of date of valuation. Amount (in customary units) of—

(a) Fully developed ore or other valuable mineral.................

....

(b) Probable or partly developed ore or other valuable mineral......

....

(c) Possible ore or other valuable mineral........................

Give name and address of party making above classification..........

....

Append a copy of the appraisal from which the estimates were derived, or append a résumé of the calculations utilized in making the estimate.

Valuation of property.

13. (a) What was the fair market value of the property as of date of valuation? .... $............

(b) Was this value ascertained:

(1) By comparison with values established by actual sales of similar properties? ....

(Yes) or (No).

(2) By appraisal? ....

(Yes) or (No).

(3) By assessed value? ....

(Yes) or (No).

(4) By other method ....

(Yes) or (No).

14. If by comparison with values of other properties established by actual sales of these properties, give the details regarding each transaction so used and your basis of comparison...

....

....

15. Give the following information regarding any bona fide transactions in similar properties in the region of the tract under discussion, about which you are able to obtain data:

(a) Property (farm).............. County............ State........

Sec.............. T................ R............ (or legal description of mining claim).

(b) Party furnishing data..

(c) Address ....

(*d*) Date of furnishing data....................................
(*e*) Source of information....................................
(*f*) Character of property transferred—fee title or leasehold?
....
(*g*) What proportion of property involved in this transaction?
....
(*h*) Name and address of vendor and purchaser....................
....
(*i*) If a lease, name and address of lessor and lessee................
....
(*j*) Date of transfer or lease....................................
(*k*) Date of first production....................................
(*l*) Total acreage of property.
(*m*) Total proven ore or other mineral at time of transfer............
(*n*) Royalty rate ....
(*o*) Average gross value per unit. (In the case of ores give assay).....
....
(*p*) Average cost of mining....................................
(*q*) Average cost beyond mine....................................
(*r*) Value of proven ore or other mineral..........................
(*s*) Any other major equipment....................................
(*t*) Value of same, $....................................
(*u*) Daily output at time of transfer or lease......................
(*v*) Total production of property prior to transfer or lease............
(*w*) Total production to date....................................
(*x*) If not a producing property, what were the indications of the value of the property as a prospective producer.
(*y*) Total cash sale price or bonus or total cash value of all considerations paid for property or lease, $....................................

16. If by appraisal give:
(*a*) The name and address of party making the same................
....
(*b*) His connection, if any, with you or with any of your associates or associated companies ....
....
(*c*) Date of making appraisal....................................
(*d*) Attach a copy of appraisal or, if such is not available, a résumé of method used in arriving at conclusions and a summary of calculations.

17. If by assessed valuation, fill out the following schedule:
(*a*) Name and address of official making the assessment..............
....
(*b*) Did the law under which the assessment was made require an appraisal of the property—
(1) At its actual cash value?....................................
(2) At a portion of its cash value?..............................
(3) If so, what portion?....................................

(*c*) What was the total assessed valuation of the property for the year of valuation? $.......................................

(1) What portion represents real property? ....

(2) What portion represents personal property? ....

(*d*) What portion of the assessed value of the real property represents mineral in ground? $.......................................

If not separated by the assessor, estimate this as nearly as you can.

18. If value established by any other method than above, append a full description of the method used and a summary of calculations.

Physical property.

19. Does the valuation as of date of valuation include any amount for plant or other physical property or for the value of the land for any other purpose than as the container of mineral deposits? ....

(Yes) or (No).

20. If your answer is "yes," what amount is applicable solely—

(*a*) To the value of the mineral contents................$............

(*b*) To the value of mill and smelter sites, rights of way, etc? $........

(*c*) To the surface or agricultural value of the land or its value for anything other than for its mineral contents or for mining and milling operations? .... $............

(*d*) To plant or other physical property?.............. $............

21. Give general inventory as of date of valuation of the physical property mentioned in 20 (*d*) with the following information regarding each type. (Use table similar to 15 (f)).

(*a*) Year originally acquired by vendor.

(*b*) Original cost to vendor.

(*c*) Depreciation sustained to date of valuation.

(*d*) Value as of date of valuation.

(*e*) Depreciation sustained by calendar years from date of valuation to date, as shown by your books.

Data indirectly relating to value as of date of valuation.

22. What was the book value of your total assets on date of valuation, exclusive of mineral in the ground?...................... $................

23. (*a*) State the number, the par value and the cash value of shares of your capital stock issued and outstanding on date of valuation:

(1) Character of issue (e. g. Common, or Preferred)..............

(2) Number of shares ....

(3) Par value of each share.................. $................

(4) Cash value of each share .... $................

(5) Total par value .... $................

(6) Total cash value .... $................

(*b*) Were any shares then outstanding not fully paid?..............

(Yes) or (No).

If so, give details in full.......................................

....

24. On what stock exchanges were your capital stock and bonds listed on date of valuation? ....

....

25. Was your stock traded in on a "curb" market on or about date of valuation? .... If so, where? ....
(Yes) or (No).

....

26. What was the quoted value of your capital stock on or about date of valuation? ....

....

27. If your stocks were not quoted on a stock exchange or curb market, give the particulars of private transactions in your stocks on or about date of valuation, so far as you have knowledge of them. If there were no transactions, how and by whom was the "cash value of each share" given in answer to question 23(4) established?

....

28. (*a*) What was your total permanent indebtedness on date of valuation? .... $................

(*b*) Classify this indebtedness showing:
(1) Bonds (describing kind) .... $................
(2) Notes (describing kind) .... $................
(3) Contracts .... $................
(4) Other (describe) .... $................

Total, as stated in 28 (*a*)............ $................

(*c*) What was the quoted value of your bonds, notes, and/or other certificates of indebtedness on date of valuation? ....

(*d*) Give sources of quotation.

....

(*e*) If your bonds, notes, and/or other certificates of indebtedness were not quoted on or about date of valuation, give particulars of public or private transactions in them on or about that date so far as you have knowledge of such transactions.............................

....

29. What were the prevailing average royalty rates stipulated in leases taken within a year of date of valuation, on mineral properties in the districts in which your properties are located? ....

....

30. State so far as known to you the names of the parties to any litigation in which the value of the mineral properties in the particular region of the property under discussion or of a partnership interest or other interest therein, or of stock in a corporation owning or operating the same, was involved on or about the date of valuation; also the name of the court or courts in which such litigation was conducted.

....

31. Attach hereto copy of report to stockholders for each of the fiscal years preceding and following date of valuation.

32. Has the value of the mineral properties in the particular region of the property under discussion or of any interest or stock therein been involved in

any partnership accounting to your knowledge on or about the date of valuation? .... If so, append statement giving particulars.

(Yes) or (No).

33. Did anyone interested in the mines in the particular region of the property under discussion or as owner, operator, or member of a partnership or stockholder in a corporation owning or operating the same die on or about date of valuation? ....

(Yes) or (No).

If so, give the name, the ownership interest, or the number of shares held, the approximate date of death, the residence at time of death, and the name and location of the court in which the estate was administered, and the name and address of the administrator, or executor.............................

....

34. If on or about the date of the valuation of the property there were any bona fide offers for its purchase, in whole or in part, or offers for the purchase of other similar properties, full details of such negotiations should be submitted. Tenders for purchase submitted through brokers or middlemen can not be considered unless supported by names of principals, together with evidence tending to show their ability and willingness to conclude the purchase in accordance with the terms of the offer made.

35. In addition to the above, attach hereto any evidence, facts, statements etc., which you deisre to have considered in the determination of the value of your property as of date of valuation.

Schedule III.

ADDITIONS TO CAPITAL ACCOUNT

Article 222 of Regulations 45 provides that at the option of the taxpayer, various items may be charged to capital account or may be deducted from gross income as an operating expense. Where a taxpayer has elected to follow one course systematically for a number of years, including 1917, he will not be permitted to amend his returns prior to 1918 for purpose of changing the method of accounting for items mentioned in this paragraph.

Has it been your practice to carry these items as capital charges or as operating expenses?

....

If as capital charges—

(a) Give a complete analysis of additions to capital returnable through depletion for each year from date of acquisition ....
....

(b) Give a complete analysis of additions to capital returnable through depreciation for each year from date of acquisition..............
....

If these items have been deducted from gross income as operating expenses, a complete analysis of operating expense for each year from date of acquisition, must be attached hereto.

Where deductions for depreciation or depletion have either been included in the past in expense or other accounts, rather than specifically as depreciation

or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

SCHEDULE IV.

FOR PROOF OF DISCOVERY.

In order to prove to the satisfaction of the commissioner that a bona fide discovery of ore or other mineral in commercial quantities has been made, you will be required, among other things, to submit the following:

1. Description of the property.

(a) Give a legal description of the property, including its location in section (or farm), township, range, county, and state.

(b) Are you the sole owner? .... If not, give your ownership
(Yes) or (No).
interest therein, and the names and addresses and ownership interest of each of the other joint owners.

(c) Is the property a leasehold? .... If so, give the name
(Yes) or (No).
and address of the lessor and the lessee........................
....

(d) Give date lease was effective ....

(e) Give date of expiration of lease...............................

(f) Give royalty rate ....

(g) State whether bonus was in cash or property......................
....

(h) Give any unusual terms of lease ....
....

2. Date of acquisition ....

3. Give the location of the nearest producing mine to the claim or tract on the date discovery [1] is claimed...
....

4. Map of property.—A map of the property on a convenient scale, preferably not less than 1 inch to 400 feet, showing, as of the date discovery is claimed: [1]

(a) The location of the tract and of the mine in question and, in addition, the development in immediately adjoining claims or tracts.

(b) The producing, suspended, or abandoned mines.

(c) Prospecting pits, shafts, trenches, drill holes, etc.

(d) The areas which are considered producing, proven, highly probable, possible, or worthless mineral land.

5. Give history of development and exploration work conducted by you from date of acquisition to the date on which descovery is claimed.

[1] The date of discovery is the date upon which it was ascertained that sufficient ore has been blocked out to justify the installation of equipment for operation on a commercial scale. The facts must be established to the satisfaction of the Commissioner.

6. Append a copy of engineer's report in which it was shown that upon this date sufficient quantities of mineral were developed to justify installation of equipment for operation on a commercial scale.

SCHEDULE V.

FOR DEPLETION.

Note.—This schedule is not to be filled out until the questions in Schedules I and/or II have been answered and the computations called for therein made.

With respect to each property producing ores or other valuable minerals during the taxable year, income from which is covered by the return under consideration, give the following facts:

1. Description of property ....
....
....

2. Value (exclusive of physical properties) as of March 1, 1913, or, if discovery is claimed subsequent to that date, value as of date of discovery or within 30 days thereafter. (See Schedule II, question 13 (*a*).)..$..........

3. Cost (exclusive of physical property, or the value of the land for anything other than its mineral contents) if acquired subsequent to March 1, 1913, and no discovery is claimed. (See Schedule I, question 14 (*a*).)..$.....

4. Estimated quantity of mineral in the ground:

(*a*) As of March 1, 1913. (See Schedule II, question 12).............
....

(*b*) As of date of discovery or 30 days thereafter. (See Schedule II, question 12) ....

(*c*) As of date of acquisition. (See Schedule I, question 12)...........
....

5. Fill out the following table:

Data desired.	Mar. 1, 1913	1914	1915	1916	1917	1918
(a) Capital sum returnable through depletion, at beginning of period (based on March 1, 1913, values)	......	......	......	......	......	......
(b) Capital returnable through depletion added during year	......	......	......	......	......	......
(c) Total capital sum against which depletion for year is chargeable [(a) plus (b)]........	......	......	......	......	......	......
(d) Estimated quantity of recoverable units of ore or other mineral in ground at end of year........	......	......	......	......	......	......
(e) Number of units mined and brought to the surface during the taxable year	......	......	......	......	......	......
(f) Unit cost of recoverable product [(c) divided by (d) plus (e)]	......	......	......	......	......	......
(g) Amount of depletion sustained during year [(f) multiplied by (e)]	......	......	......	......	......	......
(h) Gross value of output at mouth of mine........	......	......	......	XXXX	XXXX	XXXX

Note—If the "unit cost" method of computing depletion was not used in computing the depletion allowance for the various years mentioned in the above table, state what method was used in calculating the depletion and give a complete résumé of the calculations so that the commissioner may arrive at an intelligent conclusion as to whether or not the depletion allowance claimed for year was equitable and based on the actual production of that year.

6. A table must be submitted showing for each year from the acquisition of the property to 1918, inclusive, the information called for in (*b*), (*c*), (*d*), (*e*), (*f*), and (*g*) of Table 5. Item (*a*) will be the capital sum returnable

through depletion at the date of acquisition of the property, or at the beginning of each year subsequent thereto, based on cost of property.

SCHEDULE VI.

FOR DEPRECIATION.

Note.—This schedule is not to be filled out until the questions in Schedules I and/or II have been answered and the computations called for therein made.

With respect to each tract on which there is physical property, mentioned in the return under consideration, give the following facts:

1. Description of property ....

....

2. Value of physical properties as of March 1, 1913, or their cost, if acquired subsequent to that date. (See Schedule II, 20 (*d*), or Schedule I, 14 (*d*))....

....

3. Fill out the following table or one similar:

Data desired.	Mar. 1, 1913	1914	1915	1916	1917	1918
(a) Capital sum returnable through depreciation at beginning of period (based on March 1, 1913, values)	....	....	....	....	....	....
(b) Capital returnable through depreciation added during year	....	....	....	....	....	....
(c) Amount of depreciation sustained during year........	....	....	....	....	....	....

4. A table must be submitted showing for each year from acquisition of property to 1918, inclusive, the information called for in (*b*) and (*c*), of Table 3. Item (*a*) will be the capital sum returnable through depreciation at the date of acquisition of the property, or at the beginning of each year subsequent thereto, based on cost of property.

SCHEDULE VII.

FOR THE PROOF OF BONA FIDE SALE.

In proving that a bona fide sale has actually been consummated, you will be required to furnish the following information:

1. Description of the property:

(*a*) Give a legal description of the property, including its location in section (or farm), township, range, county, and state............

....

(*b*) State whether or not you are the sole owner?............... If not,
(Yes) or (No).
your ownership interest therein, and the names and addresses and the ownership interest of each of the other joint owners........

....

(*c*) Is the property a leasehold? ....
(Yes) or (No).

If so furnish the following information:

(1) Name and address of the lessor and the lessee...............

....

(2) Date lease was effective ....
(3) Date of expiration of lease...............................
(4) Royalty rate ....
(5) Whether bonus was in cash or property ....

....

(6) Any unusual terms of lease ....

....

2. Date of disposal of property ....
3. Manner of disposal of property (sale, trade, gift, etc.)......
4. (a) Amount received in cash, stock, bonds, and other considerations (to be detailed) ....

....

(b) Par value of the stock, bonds, or other obligations (to be detailed)

....

(c) Actual cash value of the stock, bonds, or other considerations on the date of disposal of the property (to be detailed) ....

....

(d) How were these cash values established.........................

....

(e) Name and address of the party determining or establishing these values ....

....

5. (a) Name and address of the party to whom the property was transferred ....

....

(b) The connection, if any, between the party or parties disposing of the property and the party making the purchase or with any of his associates or associated companies ....

....

6. In disposing of the property, was the price at which the property was sold fixed for the purpose of a bona fide purchase and sale by which the property passed to an owner in fact as well as in form different from the vendor? .... No fictitious nor inflated sale price will be permitted to form (Yes) or (No).
the basis for the price established for this schedule.

7. Give any evidence, facts, statements, etc., which you desire to have considered as proof in the determination of the bona fide character of the transaction.

Schedule VIII.

FOR COMPUTATION OF PROFIT OR LOSS FROM SALE OF CAPITAL ASSETS.

Note.—This page is not to be filled out until the questions in the schedules called for herein have been answered and the computations called for therein made.

With respect to each property disposed of during the year you are requested to furnish the following information:

1. Description of property..

....

2. Date of disposal of property ....
3. Manner of disposal of the property (sale, trade, gift, etc.) ....

....

4. Amount received in cash .... $..............
5. Amount received in stock:
   (a) Par value of stock .... $..............
   (b) Actual cash value of stock .... $..............
   (c) How was this cash value established? ....

....

6. Amount received in bonds:
   (a) Par value of bonds............................ $..............
   (b) Actual cash value of bonds.................... $..............
   (c) How was this cash value established? ....

....

7. Amount received in other considerations:
   (a) What were these considerations? ....

....

   (b) Actual cash value of these considerations....... $..............
   (c) Manner of determining this cash value.........................

....

   (d) Name and address of the party determining this value...........

....

8. Cash value of all considerations received for property..$..............
9. Value of property as of March 1, 1913, or its cost if acquired subsequent to that date. (See Schedule I, question 8 (g), or Schedule II, question 1...)
.... $..............

10. Total of all additions to capital returnable through depletion added subsequent to March 1, 1913, or subsequent to date of acquisition if property acquired subsequent to March 1, 1913. (See Schedule V, question 5 (b).)
$..............

11. Total of all additions to capital returnable through depreciation added subsequent to March 1, 1913, or subsequent to date of acquisition if acquired subsequent to March 1, 1913. (See Schedule VI, question 3 (b).)
$..............

12. Gross value of property as of date of disposition. (Total 9, 10, and 11.)
$..............

13. Total depletion sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property. (See Schedule V, question 5 (g).)...........$..............

14. Total depreciation sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property. (See Schedule VI, question 3 (c).)...$..............

15. Net value of property as of date of disposition of property (12 less the sum of 13 and 14) ....$..............

16. Profit or loss sustained from disposition of property (difference between 8 and 15) ....$.................

SCHEDULE IX.

FOR PROVING THAT THE PRINCIPAL VALUE HAS BEEN DEMONSTRATED BY PROSPECTING OR EXPLORATION AND DISCOVERY WORK DONE BY THE TAXPAYERS.

In the case of the bona fide sale of mineral properties, or any interest therein, in order to take advantage of the clause in Section 211-b of the Revenue Act of 1918, which limits the portion of the tax imposed by said Act attributable to such sale to a sum not to exceed twenty per centum of the selling price of such property or interest, you will be required to furnish the following, under oath, in order to satisfy the Commissioner that the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer:

1. Description of the property.

(*a*) Give a legal description of the property, including its location in section (or farm), township, range, county, and state..............

....

(*b*) Are you the sole owner?.............. If not, give your ownership
(Yes) or (No).
interest therein, and the names and addresses and ownership interest of each of the other joint owners............................

....

(*c*) Is the property a leasehold?.............. If so, furnish the follow-
(Yes) or (No).
ing information:

(1) Name and address of the lessor and the lessee................

....

(2) Date lease was effective.......................................

(3) Date of expiration of lease...................................

(4) Royalty rate ....

(5) Whether bonus was in cash or property.......................

....

(6) Any unusual terms of lease...................................

....

2. The value of the property immediately prior to the date of beginning prospecting or exploration and discovery work done by you leading to the discovery claimed. (This value must be established through filling out Schedule II, as of the specified date immediately prior to the discovery.)

3. The proof that a discovery has been made. (To furnish this proof you will be required to fill out Schedule IV.)

4. The value of the property at any specified date within a reasonable time after the discovery was made. (This value may be established by filling out Schedule II as of the specified date.)

5. Give any evidence, facts, statements, etc., which you desire to have con-

sidered as showing that the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by you.

I swear (or affirm) that the answers to the questions herein, including statements and figures entered in the accompanying schedules and in any additional statements and schedules attached hereto, are, to my best knowledge and belief, true and correct in each and every particular.

....
(Signature of individual or agent.)

Sworn to and subscribed before me this..........day of..................
(Month.)

....
(Year.)

....,
(Signature.)

....
(Title.)

We, the undersigned, general officers of ....
....
(Name of corporation, partnership, or association.)
being severally duly sworn, each for himself deposes and says that the answers to the questions herein, including statements and figures entered in the accompanying schedules and in any additional statements and schedules attached hereto, are, to his best knowledge and belief, true and correct in each and every particular.

....
(Signature, state title.)

....
(Signature, state title.)

Sworn to and subscribed before me this..........day of................
(Month.)

....
(Year.)

....
(Signature.)

....
(Title.)

GENERAL FOREST INDUSTRIES QUESTIONNAIRE. FORM T.

GENERAL INFORMATION

1. The taxpayer in this case is an:
   Individual........ Partnership........ Corporation........
   (Place "Yes" after proper one.)
2. (Indicate relation to other companies, if any.)
   Parent company of..
   Subsidiary company of..
3. Date of original organization......................................
4. Date or dates of reorganizations...................................
5. Principal office located at..
6. Books located at ....
7. Manufacturing plants located at....................................
8. Income tax return filed in...
   (City.) (Location of Internal Revenue Collector's office.) (State.)
9. President of corporation.................., ...
   (Name.) (Address.)
10. Manager of corporation.................., ...
    (Name.) (Address.)
11. If forest industry part of business is subsidiary to principal business of corporation, give also name and address of man managing forest industry portion of business.

..............................., ...
(Name.) (Address.)

TIMBERLAND

BLOCKS

12. Definition: The block is—

An operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture (or to one of a group of interchangeable points of manufacture); however, in those cases in which the point of manufacture is at a considerable distance, or in which the logs will probably be sold in a log market, as on Puget Sound, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development.

(The "grouping of species" within a given block, which may be especially authorized by the Commissioner, is discussed under number 167.)

Since it is required for depletion purposes that there be carried on the books of the taxpayer a separate account for each block of timber, or for each species or group of species valued separately, the block should, for simplicity

in accounting, be made as large as possible, within the limitations indicated above.

13. State the number of blocks into which the timberland of the taxpayer is divided ....

14. State the names of the blocks..

....

....

(The names should usually be derived from some important natural object such as a river, mountain, bay, etc.—"Clearwater River Block.")

KEY MAP

15. For each State in which the taxpayer has timber he should furnish a key map of the holdings showing block boundaries. If the location of the taxpayer's mill (or mills) at which the timber is likely to be manufactured is within the territory covered by the key map, its (or their) location and character should be shown on the map. This map should be on a scale of not less than 1 inch equals 20 miles. No attempt should be made to differentiate between property of the taxpayer and other property within block boundaries; the block boundaries should be drawn to inclose as closely as possible the property of the taxpayer. This data will be most acceptable if entered upon a State map, or portion of a State map, which shows such features as mountain ranges, streams, towns, railways, highways, etc.

BLOCK MAPS

16. For each block the taxpayer should furnish a map in which 1 inch represents from one-fourth mile to 2 miles. The block map should give as much as practicable of the following information: Name of taxpayer, arrow pointing north, scale, date when made, maker, State in which located, county boundaries, public survey lines, topography, streams and bodies of water, towns, railways, highways, logging and manufacturing improvements.

Legend—(¶¶ 17 to 22):

17. Merchantable timber owned on March 1, 1913 (whether or not land under timber was also owned). This classification should include areas from which part, but not all, of the merchantable timber had been removed before March 1, 1913.) (Colored green.)

18. Cut over and other land not bearing merchantable timber owned on March 1, 1913. (Uncolored, with black diagonal hatching.)

19. Merchantable timber acquired on or after March 1, 1913 (whether or not land under timber was also acquired). (This classification should include areas from which part, but not all, of the merchantable timber had been removed before it was acquired by the taxpayer.) (Colored yellow.)

20. Cut over land and other land not bearing merchantable timber acquired on or after March 1, 1913. (Uncolored, with black horizontal hatching.)

21. Merchantable timber cut on or after March 1, 1913. (If the merchantable timber has been cut clean the hatching lines should be unbroken; if only

part of the merchantable timber has been cut the hatching lines should be broken.) (Colored green or yellow, with black vertical hatching.)

22. Merchantable timber or untimbered land sold, or otherwise disposed of, on or after March 1, 1913 (land sold from beneath timber should not be included). (Colored or hatched as above, with red diagonal hatching.)

23. In the above, "merchantable timber" should be taken to mean timber occurring in sufficient quantity, and of a size and quality to justify an operation in the given region to convert it into useful products. For the purpose of mapping, quantity, size, and quality, but not accessibility, are considered factors of merchantability; this is because it is desired in the maps to show the *character* of the timber rather than its relative value. The above legend is suggested but not required; the legend used should give the information indicated. The various hatchings should be superimposed on the coloring or on each other to show the changes in condition, if any. The data may be shown on a single map or on sectional maps. The variation in scale indicated above is intended to permit entering the data upon existing maps in the possession of or available to the taxpayer. It is not intended that field work shall be done to gather the map data; the data indicated so far as now available in the taxpayer's records should be compiled. In regions such as the Appalachians, where there have been no public land surveys, and in those cases in which the taxpayer's holdings have not been accurately surveyed and mapped, the size, shape, and location of the holdings should be mapped as accurately as practicable from the data on hand, and a statement should show that the land has not been accurately surveyed.

24. It is expected that the taxpayer will retain a copy of each map, as well as of other parts of this report, for it is contemplated that it will be necessary each year in the future to furnish data which may be used in keeping the maps up to date.

IMPORTANT PURCHASES AND SALES

Information relating to important purchases and sales of timber land is needed to be used, in connection with other information, in determining the "fair market value" of timber as of March 1, 1913. See Treasury Decision 2916.

25. For the period from January 1, 1910, to December 31, 1916, inclusive, give the data indicated from 25 to 80, inclusive, for each transaction involving the purchase or sale of timber, or land, or both, involving over 1,000 acres. It is not intended that surveys or cruises shall be made in the field to obtain any of the data indicated; data now existing in the taxpayer's records should be compiled to furnish this information. In case one body of timber or land, or both, has been traded for another, that given up should be considered *sold* and that received should be considered *purchased.*

26. Is the transaction described a purchase or sale? ....

27. Name of block in which the property is located ....

(If a sale included timber not in any block, so state.)

28. Name of property: ....

(The local name, such as "Brown Tract," should be given.)

29. Location of property. (Describe by legal subdivision; if this can not be done, describe as definitely as possible. This information will be more useful if shown on a map, if one is available, than if located by a description. In case a map is furnished no description is needed.)

30. Is (or was) the taxpayer the sole owner of the property? ....

31. If not, describe his interest therein, and give the name, address, and ownership interest of each of the other joint owners.

32. Date property was transferred ....

33. State the manner of the transfer (purchase, sale, trade, gift, etc.) ....

34. Amount paid in cash, $............

35. Amount paid in stock, $............

36. Par value of stock, $............

37. Actual cash value of stock, $............

38. How was this cash value established? ....

39. Amount paid in bonds, $............

40. Par value of bonds, $............

41. Actual cash value of bonds, $..........

42. Amount paid in other considerations, $............

43. What were the other considerations? ....

44. Actual cash value of such considerations, $............

45. Manner of determining this cash value.

46. Give the name and address of person establishing value, and state his connection, direct or indirect, if any, with the taxpayer or with the other party to the transaction.

.........................., ...
(Name.) (Address.)

47. Append a copy of the report of the person establishing the cash value or a résumé of his report.

48. Total cash value of all considerations paid for property, $..........

49. If payment was not completed on the date of acquisition, describe the nature of the payments as to amounts, dates, security given, etc.

50. Did the transfer include the land, the timber, and all rights pertaining thereto? ....
(Yes or No.)

51. If not, state what was transferred and under what conditions.

52. Total area, ...acres.

Allocate the total area to 53, 54, and 55 in accordance with conditions existing upon the date of transfer:

53. Area upon which there was a stand of merchantable timber. ....acres.

54. Area upon which there was a stand of young timber still too small to be cut for a useful purpose, ...acres.

55. Area of other sorts of land, ...acres.

For area 53, above, give the data indicated under 56, 57, 58, and 59.

56. Total estimated quantity of timber present upon the date of transfer,

....
(Unit.)

(The "unit" indicated here and elsewhere in this report should be that com-

monly used in the given region to measure forest products; such units include board feet, cords, standards, etc.; if the timber present is commonly measured in more than one unit, on account of diversity of its character, state the quantities of different character which need to be kept separate in the different appropriate units.) This estimate should include, as nearly as the taxpayer can determine the quantity, 100 per cent of the timber which the area would have produced if all of the merchantable timber had been cut on the date of the transaction, and if it had been utilized in accordance with the custom generally prevailing in that region at that time. The unit (or units) in which the quantity is stated should be the unit customarily used in the woods, not that used to measure manufactured products; for example, the quantity of saw timber should be stated in terms of board feet, log scale, not in terms of board feet, lumber tally, based on the quantity of lumber which could be sawed from the logs in the mill.

57. Describe the unit (or units) of measure used in this case, as, for instance, "board feet, log scale, based on Doyle log rule;" "stacked cords, 4 feet by 4 feet by 8 feet, rough (or peeled or rossed);" etc.

58. State the per cent of each species of timber, based on units of volume, present in each classification of 56. If information with respect to the per cent of each species is incomplete, give such information as the taxpayer has, as, for example, the per cent of a few leading species with others lumped, or the per cent of hardwoods and the per cent of softwoods, etc. If any dead timber is included in the estimate, state the per cent of the total and the per cent of each species.

59. So far as the taxpayer has the information, describe the important tree species with reference to size and quality by some means, such as: the average number of logs per tree or the merchantable length; the average number of logs per 1,000 feet, board measure, log scale; per cent by volume in different recognized log grades; average number of trees per cord; per cent of defect, etc. This information is intended to bring out as clearly as possible the character and condition of the timber on account of the effect upon value.

60. For area 54, above, describe the young timber as clearly as possible with reference to the proportion of the species of trees present, the average size of the trees, etc.

61. Total price of tract, \$.........., allocated to 62, 63, 64, and 65 in accordance with their relative values on the date of transfer:

> 62. Land (separate from timber), total, \$........., or \$......... per acre. If the land was not a factor in the value, no value should be stated. If various classes of land of distinctly different values per acre are included, the taxpayer should, if he believes that it will present the situation more clearly, name each class, state its acreage, allocate to it the proper share of the price, and state the price per acre.
>
> 63. .... (Unit.) of merchantable timber (as stated in 56) price \$.........., or \$.......... per .... (Unit.) This total price of merchantable timber is allocated to the several species or groups of species

as follows: (a) ...., ..., price $..........,
(Species.) (Unit.)
or $.......... per ...., and so on for each species or group
(Unit.)
of species. In the above, group together any species having the same unit price, naming the species in each group. If dead timber is included in the estimate, report also the price at which it is included, dividing it into species or groups of species, as in the case of green timber. If more than one unit of estimate was used in 56, the above data should be furnished separately for each unit.

64. .... acres of young timber, price $.......... total, or $.......... per acre.

65. Other valuable considerations included with the timber and land in the transaction, such as mineral, mineral rights, turpentine rights, hunting rights, waterpower sites, farm improvements, logging improvements, lumber manufacturing improvements, personal property, etc. Total price, $...........

Give an itemized inventory, naming each item, and stating its price. (Such data should be given at this point only when the property of this class was transferred in a transaction involving timber land.)

66. Give name and address of the forest engineer, timber cruiser, or other person who estimated the quantity of timber present, mapped and classified the land, and/or placed a value upon the property, and state his connection, direct or indirect, if any, with the taxpayer or with the other party to the transaction.

....
(Name.) (Address.)

....

67. Date upon which such estimate was completed........................

68. Describe method of making estimate..................................

....

69. Attach copy or résumé of report. (It is not desired that detailed estimates by 40-acre or other small subdivisions be furnished; a summary of estimates will be sufficient. Similarly, it is not intended that detailed maps of small subdivisions be furnished. With the exception of such detailed data as that just mentioned, the report should be furnished.)

NOTE.—Since for the sake of conservatism, estimates have frequently, if not usually, been made with the object of showing less than 100 per cent of the timber actually present, and since individual estimators have their personal equation, it is not expected that the estimate stated in 56 above will necessarily agree with the report.

70. If no cruise, survey, classification, or valuation was made, so state.

....

71. If the taxpayer has cut all or any of the timber included in this transaction (include such data in the case of *purchases* only, and so far as the records show the facts), give the information indicated in 72 to 78, inclusive, for the cut over areas for which records are available. These data should cover the period from the date of acquisition to December 31, 1918, without separation by years.

72. Area of timber land cut over, ... acres.

73. Estimated quantity of timber on area cut over. (This estimate should be the one given in the cruiser's report.) ....
(Unit.)

74. Quantity of timber actually cut, ...
(Unit.)

State what scale rule was used and how it was applied.

75. Quantity of timber left for later cutting, ...
(Unit.)

76. Quantity of timber abandoned, ...
(Unit.)

77. Quantity of timber cut plus quantity left plus quantity abandoned (74 plus 75 plus 76), ... (Unit.) (The unit used in 73, 74, 75, 76, 77 must be the same throughout.)

78. Percentage by which actual cut plus timber left plus timber abandoned (77) exceeded or fell short of estimate (73). { Excess .... per cent. Shortage .... per cent. }

79. If in the case of the property included in this transfer there were any factors in addition to those shown in the maps which made it exceptionally cheap and easy, or expensive and difficult to remove the products, thus giving the property an exceptionally high or an exceptionally low value, discuss those factors and their effect upon the price.

80. If for any reason the prices of land, timber, or other property in this transaction do not represent the fair market value as of the date of the transaction, explain in what respect, to what extent, and why they differ.

81. If the taxpayer has information with regard to other transactions, whether or not he was a party to such transactions, which in his judgment represent fair market values as of the date of the transaction, he may, if he desires, report them in the form outlined above. Such transactions need not be limited to those exceeding 1,000 acres, or to those made January 1, 1910, to December 31, 1916, inclusive. This paragraph should not be understood to place any obligation whatever on the taxpayer, but merely to suggest to him the opportunity to present other relevant data.

STATUS AS OF MARCH 1, 1913

For purposes of computing the deductions for depletion of timber it is necessary to ascertain the status of timber holdings as of March 1, 1913. See Regulations 45, articles 227, 228, 202, 203, 204, 205, 230, 231, and 216 and Treasury Decision 2916.

82. Give the information indicated in 82 to 111, inclusive, for each block separately. *All* of the taxpayer's timberland in the block taken in the aggregate should be included. The data should present the conditions which existed on March 1, 1913.

83. Name of block, ...

84. Was the taxpayer the sole owner of the block? ....
(Yes or no.)

85. If not, state the taxpayer's interest therein, and the name, address, and ownership interest of each of the other joint owners.

86. Did the property owned in this block include the land, the timber, and all rights pertaining thereto? ....

(Yes or no.)

87. If not, describe what was owned, and under what conditions.

88. Total area, ... acres.

Allocate the total area to 89, 90, and 91 in accordance with conditions which existed upon March 1, 1913, so far as the taxpayer's existing records give or permit the compilation of the information.

89. Area upon which there was a stand of merchantable timber. .... acres.

90. Area upon which there was a stand of young timber still too small to be cut for a useful purpose, ... acres.

91. Area of all other kinds of land, ... acres.

92. For area 89 above, give the data indicated in 93 to 98, inclusive.

93. Total quantity of merchantable timber estimated to have been present upon March 1, 1913, ...

(Unit.)

(See note with reference to "unit" under 56, which also applies here.)

Note.—The quantity of standing timber on hand on March 1, 1913, is not necessarily the quantity estimated to have been present on the date of acquisition. It should be the quantity actually present on March 1, 1913, according to the best knowledge and belief of the taxpayer. It should be the quantity which would have been found present by a careful estimate made on that date with the object of determining 100 per cent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. The unit (or units) in which the quantity is stated should be the unit customarily used in the woods, not that used to measure manufactured products; for example, the quantity of saw timber should be stated in terms of board feet, log scale, not in terms of board feet, lumber tally, based on the quantity of lumber which could be sawed from the logs in the mill.

94. Describe the method by which the taxpayer arrived at the quantity of timber stated in 93...
....

95. Average number of units of merchantable timber per acre, ...

96. Describe the unit (or units) of measure in this case. (See 57.) ....
....

97. State the per cent of each species of timber based on units of volume, present in each classification of 93. If information with respect to the different species is incomplete, give such information as the taxpayer has, as, for example, the per cent of the more important species with others lumped, or the per cent of hard woods and the per cent of soft woods, etc. If any dead timber is included in the estimate, state the per cent of the total and the per cent of each species.

98. So far as the taxpayer has the information, describe the important tree species with reference to size and quality by some means such as: the average number of logs per tree or the merchantable length; the average number of logs per 1,000 feet, board measure, log scale; per cent by volume in different recognized log grades; per cent of defect; etc. This information is intended to bring out as clearly as possible the character and condition of the timber on account of the effect upon value.

99. For area 90 above, describe the young timber as clearly as possible with reference to the proportion of the different species of trees present, the average size of the trees, etc.

100. Give the name and address of the forest engineer, timber cruiser, or other person, if any, who estimated the quantity of timber present and mapped and classified the land and/or placed a value upon the property in the block on or about March 1, 1913. State his connection, direct or indirect, if any, with the taxpayer.

............................, ...
(Name.) (Address.)

101. Date upon which estimate was completed, ...

102. Describe method of making estimate: ....

....

103. Attach copy or résumé of report. (See parenthetical note in 69 with reference to furnishing summaries rather than detailed estimates, etc.)

Note.—Since for the sake of conservatism, estimates have frequently, if not usually, been made with the object of showing less than 100 per cent of the timber actually present, and since individual estimators have their personal equation, it is not expected that the estimate stated in 93 above will necessarily agree with the report.

104. If no cruise, survey, classification or valuation was made, so state.

105. Total fair market value of block, $.........., as of March 1, 1913, allocated to 106, 107, 108, 109, and 110 in accordance with their relative values on that date.

106. Land (separate from timber) total $........., or $......... per acre. If the land was not a factor in the value, no value should be stated. If various classes of land of distinctly different values per acre are included, the taxpayer should, if he believes that it will present the situation more clearly, name each class, state its acreage, allocate to it the proper share of the value and state the value per acre. The books of account of the taxpayer should show clearly the value set upon those different portions of his land, if any, which are valued separately. Each of such portions should be clearly described in his records, but need not be described here.

107. Timber. .... of merchantable timber (as stated in 93)
(Unit.)
value $.........., or $......... per ....
(Unit.)

This total value of merchantable timber is allocated to the several species or groups of species as follows:

108. (a) ...., ..., value $........... or
(Species.) (Unit.)
$.......... per ....; make a similar statement for each
(Unit)
species or group of species.

Note.—In the above, group together any species having the same unit value, naming the species in each group. If dead timber is included in the estimate, report also the value at which it is included, dividing it into species or groups of species as in the case of green timber. If more than one unit of estimates was used in 93, the above data should be furnished separately for each unit.

Since the estimated quantity of timber stated is on a 100 per cent basis, great care should be taken that the value placed upon the timber is based on a 100 per cent estimate and not on some other sort of estimate.

109. .... acres of young timber, value $.........., total, or $.......... per acre.

110. Other items of value, total $........... Other valuable things making up part of the fair market value of the real estate in the block, such as mineral, mineral rights, turpentine rights, hunting rights, water-power sites, etc., should here be listed, described, valued, and a clear statement should be made in justification of the value claimed. Physical property described, 200 to 210, inclusive, in this report should not be included here.

111. Submit any statements or evidence which the taxpayer may wish to present in addition to that given above which will tend to show the fair market value of his timber land as of March 1, 1913.

PURCHASES, MARCH 1, 1913, TO END OF 1918

112. For the period from March 1, 1913, to the end of the taxable year 1918, inclusive, give for each taxable year and each block separately the data indicated, 112 to 132, inclusive, for the aggregate of purchases of timber or land or both. (The data should be as of the date of the purchase.) If the taxpayer keeps separate in his accounts the timber owned on March 1, 1913, from that acquired since that date, or if a separate account is set up for each tract acquired since March 1, 1913, this statement should cover each such account. If, in compliance with the above, it should become necessary to redescribe one of the purchases already described, 25 to 80, there should at this point be entered merely a reference which will definitely identify the purchase previously described.

113. Location of property. (Describe by legal subdivisions; if this can not be done, describe as definitely as possible. This information will be more useful if shown on a map, if the taxpayer has one available, than if located by a description. In case a map is furnished showing the location of the property, no description is needed.)

114. Is the taxpayer the sole owner of the property? ....
(Yes or no.)

115. If not, describe the taxpayers' interest therein, and give the name, address, and ownership interest of each of the other joint owners.

116. State the manner of acquisition (purchase, trade, gift, etc.) ....

117. State the amount paid in cash or its equivalent, $..........

118. Did the acquisition include the land, the timber, and all rights pertaining thereto? ....
(Yes or no.)

119. If not, state what was acquired and under what conditions.

120. State the total area, ... acres.

Allocate the total area to 121, 122, and 123 in accordance with conditions existing upon the date of acquisition:

121. Area upon which there was a stand of merchantable timber, ... acres.

122. Area upon which there was a stand of young timber still too small to be cut for a useful purpose, ... acres.

123. Area of other sorts of land, ... acres.

For area 121 above, give the data indicated under 124 to 127, inclusive.

124. Total quantity of timber estimated to be present upon the date of acquisition, ... (Unit.) (See note in 56 relating to units; it applies here also.)

125. Average number of units of timber per acre, ...

126. Describe the unit (or units) of measure in this case (see 57) ....
....
....

127. State the per cent of each species of timber, based on units of volume, present in each classification of 124. If the taxpayer has incomplete information with respect to the per cent of each species, such information as is available should be given, as, for example, the per cent of a few leading species with others lumped together, or the per cent of hard woods and the per cent of soft woods, etc. If any dead timber is included in the estimate, state the per cent of the total and the per cent of each species.

128. Total cost of property, $.......... Allocate this total cost to 129 130, 131, and 132 in accordance with their relative values on the date of acquisition.

129. Land (separate from timber), total, $.........., or $.......... per acre. If the land was not a factor in the price, no price should be stated. If various classes of land of distinctly different values per acre are included, the taxpayer should, if he believes that it will present the case more clearly, name each class, state its acreage, allocate to it the proper share of the price and state the price per acre. The books of account of the taxpayer should show clearly the value set upon those different portions of the land, if any, which are valued separately. Each of such portions should be clearly described in his records, but need not be described here.

130. .... (Unit.) of merchantable timber (as stated in 124) cost $.........., or $.......... per .... (Unit.)

131. .... acres of young timber, price $......... total, or $...... per acre.

132. Other valuable things, $.......... total. Here give the sort of data indicated under 110.

SALES, AGGREGATE FOR EACH BLOCK, MARCH 1, 1913, TO END OF 1918

133. For the period from March 1, 1913, to the end of the taxable year 1918, inclusive, give for each block for each taxable year separately the data indicated for the aggregate of sales of timber or land or both. These data should be given separately for each timber or land account if there is more than one account for the block. The information should be as of the date (or dates) of the sales (or sales).

134. Total area, ... acres.

Allocate the total area to 135, 136, and 137.

135. Area upon which there was a stand of merchantable timber, ... acres.

136. Area upon which there was a stand of young timber still too small to be cut for a useful purpose, ... acres.

137. Other areas, ... acres.

For area 135 above, give the data indicated in 138.

138. Total quantity of timber estimated to be present upon the date of sale, ...

(Unit.)

(See note in 56 relating to units; it applies here also.)

LOSSES

139. If the taxpayer's standing timber has since March 1, 1913, sustained any losses due to fire, floods, insects, wind or other causes, if the quantity of timber so lost has been definitely ascertained, and if any such losses have been reported in an income tax return to the Bureau of Internal Revenue, give for each timber account separately the data indicated in 140 to 158, inclusive, with respect to each such loss. See Regulations 45, article 141.

140. Cause of loss.

Area upon which loss took place of:

141. Merchantable timber .... acres.

142. Young timber .... acres.

143. Total .... acres.

For each loss to merchantable timber, 141, give the data indicated in 144 to 148 inclusive.

(a) 144. For each species named below report in columns (b) and (c).	(b) Total quantity destroyed or rendered useless (board feet, cords, etc.).	(c) Quantity per acre destroyed or rendered useless (cords, etc.).
....	....	....
....	....	....

145. If the timber was not destroyed, or rendered useless, but merely reduced in value, show that fact.

146. If any of the timber was salvaged, state the quantity of each species salvaged.

147. If, in addition to the timber directly damaged, there is other timber the value of which has been reduced by the damage, show that fact; state the amount of the financial loss; indicate clearly how that amount was determined.

148. The net financial loss to merchantable timber, $..........

For each loss to young timber, 142, give the information indicated in 149, 150, and 151.

149. Describe the young timber injured as clearly as possible with reference to age, size, species of trees, etc.

150. Percentage of original number of young trees killed, ...

151. Financial loss resultant from damage to young timber, $..........

152. Total financial loss to merchantable timber and to young timber, $..........

153. Approximate date upon which (or dates between which) loss took place ....

154. Date upon which the quantity of damage was definitely ascertained ....

155. State how the damage was ascertained..................................

156. State the name and address of the person by whom the damage was ascertained and state his connection, direct or indirect, if any, with the taxpayer ....

157. Attach a copy of the report, if any was made.

158. State the year for which the loss was reported in an income tax return to the Bureau of Internal Revenue ....

PROTECTION OF TIMBER

159. Describe briefly any special measures taken by the taxpayer to protect his timber from damage by fire, insects, or other causes.

160. For each year from 1910 to 1918, inclusive, state the amount expended for such protective work. (This should include direct expenditures, payments of assessments to protective associations, taxes collectible and usable solely for protection, etc. No fines or collections of a punitive nature for failure to observe protection laws should be included.)

161. Does this protective work definitely aim to protect the young timber?

....
(Yes or no.)

GROWTH

162. If the taxpayer has any data or estimates on the subject, state the approximate rate of increase in the quantity of timber as the result of growth. The information, if available, should be given separately for each of the different types of timber.

163. For merchantable timber—Average annual net growth per acre,

....
(Unit.)

164. For young timber—Average annual net growth per acre, ...
(Unit.)

165. Is the taxpayer managing his timber land with the object of producing one or more crops of timber after the present crop is harvested? ....
(Yes or no.)

166. If "yes," outline briefly the system of management used.

VALUATION OF TIMBER BY SPECIES OR GROUPS OF SPECIES

167. In some regions it is customary to cut and remove from the forest one or more species of trees several years before the remainder of the timber is cut. If this is done in logging the taxpayer's timber, and if the value of the species or group of species removed in advance is substantially different from that of the timber remaining, the taxpayer may find that the unit depletion charge, based on the average value of all of the species present, is inequitable. If this is the case, the taxpayer may, subject to the approval of the Commissioner, divide the timber into two or more species or groups of species in valuing the timber for purposes of depletion. If the taxpayer finds such action necessary, a statement should be made at this point showing clearly the necessity for such action. Since the cost of both field and bookkeeping operations will probably be increased, such a step should not be undertaken unless clearly necessary. If such a division into species or groups of species is made, a separate account should be set up on the taxpayer's books for each such division. Under status as of March 1, 1913, 82, above, and purchases, 130, above, there should be introduced data which show clearly the proposed division into species or groups of species; give the total quantity of timber in each division, and state the total and unit value, or cost, as the case may be.

TIMBER-CUTTING RECORDS

With respect to each block from which timber has been cut in the taxable years indicated, give the data indicated in 168 to 186, inclusive.

168. Name of block ....

	1910	1911	1912	1913	1914	1915	1916	1917	1918
169. Acres of timberland cut over									
170. Total quantity actually cut[1] in M ft. b. m., cords, or other unit (state unit)									
171. Percentage by volume of each species cut. 1									
2									
Name important species kept separate in scale records, setting proper per cents opposite each. 3									
4									
5									
Miscellaneous									
Total per cent	100	100	100	100	100	100	100	100	100
172. Quantity of timber left for later cutting (state unit)									
173. Quantity of timber abandoned (state unit)									
174. Total quantity cut, left for later cutting, and abandoned (state unit)									
175. Total quantity cut, left, and abandoned per acre (state unit) (174 divided by 169)									

[1] This unit should be log scale or other unit as measured in the woods. If the scaling was not done as indicated in 74, describe how it was done.

If the taxable year does not coincide with the calendar year, give these data for the taxable year indicating the date of beginning of the taxable year.

176. Give the reasons why the timber was left for later cutting or abandoned.

177. Give a rough description of area from which the timber was cut each year by approximate legal subdivisions; if the taxpayer prefers, he may give this data by submitting a block map showing the area cut over during each of the above years; a map will be more acceptable to the Commissioner.

178. For those areas included in Tables 169 to 175 above, so far as they have been estimated since January 1, 1910, and so far as it is practicable to check the areas estimated by actual cut, give the data indicated in 179 to 186, inclusive, or as much of it as possible. Since a separate table—169 to 175—is prepared for each block, this table also will be prepared separately for each block.

179. Name of block ....

		A	B	C	D
180. Acres of timber land cut over					
181. Total quantity of timber estimated on land cut over					
182. Total quantity actually cut					
183. Quantity of timber left for later cutting					
184. Quantity of timber abandoned					
185. Total of 182, 183, and 184					
186. Percentage by which 185 exceeds or falls short of 181.	Excess				
	Shortage				

A, B, C, D, etc., represent estimates made at different times. For each state the year in which the estimate was made, and the name of the cruiser who made the estimate.

DEPLETION CHARGED

187. Here enter the amount stated in the taxpayer's income tax returns as an allowance for depletion or as an expense on account of timber cut during each taxable year indicated. Give this information separately for each timber account. Give also a summary table which states the totals for the taxpayer of the data given in the table for the separate accounts.

Name of account ....

Taxable year.	Total amount. (Dollars.)	Dollars per unit [1] of timber.
1913		
1914		
1915		
1916		
1917		
1918		

[1] This unit should be the same as that used in 170 above.

CAPITAL RETURNABLE THROUGH DEPLETION

188. The data indicated in this table should be given separately for each timber account which you are carrying in your books. A summary table should be given to state the totals for the taxpayer of the data given in the tables for the separate accounts.

Name of account	Mar. 1, 1913, to end of taxable year.		1914		1915		1916		1917		1918	
	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars).	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars)	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars).	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars).	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars).	Quantity in M feet board measure, log scale, or other unit.[1]	Value (dollars)
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
189. Estimated quantity of timber and amount of capital returnable through depletion at beginning of year												
190. Acquired during year												
191. Total at end of year												
192. Quantity of timber cut during year		X X		X X		X X		X X		X X		X X
193. Unit value returnable through depletion (191 column (2) divided by 191 column (1))	X X X		X X X		X X X		X X X		X X X		X X X	
194. Depletion sustained during year (192 (1) multiplied by 193 (2))	X X X		X X X		X X X		X X X		X X X		X X X	
195. Balance at end of year (191 (1) minus 192 (1) and 191 (2) minus 194 (2))												
196. Quantity of timber sold during year		X X		X X		X X		X X		X X		X X
197. Quantity of timber lost by fire, or other cause, or abandoned during year		X X		X X		X X		X X		X X		X X
198. Total reduction in addition to 192 and 194, (196 (1) plus 197 (1); 198 (1) multiplied by 193 (2))												
199. Net quantity and value at end of year (195 minus 198)												

[1] If M feet board measure, log scale, is not the unit used, state what unit is used.

PHYSICAL PROPERTY

200. Information is needed with relation to physical property in order to compute depreciation. For a definition of physical property and a discussion of depreciation see Regulations 45, articles 103, 161, 162, 163, 164, 165, 166, 169, 170, 216, 231, 232, 839, and 840.

201. Give an inventory of the physical property of the taxpayer in conformance with the accounts carried on the books, arranging the different classes and items of property carried on the books in accordance with the classification indicated below. The information indicated should be given for each item of property listed.

(a) Year originally acquired or constructed by taxpayer.

(b) Original cost to taxpayer.

(c) Estimated years of useful life from date of acquisition or construction. This estimate should take into consideration (1) the years required to cut not only the timber now owned by the taxpayer but also the timber not now owned which in all probability will be obtained for his operation, and (2) the period during which the given item of physical property will remain in a usable condition.

(d) Estimated salvage value at the end of the period of useful life.

Note.—For property acquired prior to March 1, 1913, furnish the information called for under (e), (f), (g), and (h); for property acquired on or after March 1, 1913, these headings do not apply.

(e) Additions to or reductions of capital returnable through depreciation from date of acquisition or construction by taxpayer to March 1, 1913. (Give only the net addition or reduction for the same item, using black ink for additions, and red ink for reductions.) (See note 1 below.)

(f) Depreciation actually written off from date of acquisition by taxpayer to March 1, 1913 (whether credited to the asset or set up in a reserve. (See note 1 below.)

(g) Net cost or book value as of March 1, 1913.

(h) Market value as of March 1, 1913. (See note 2 below.)

(i) For the period from March 1, 1913, to the end of that taxable year, and for each of the taxable years 1914 to 1918, inclusive, give for each of the items included in the inventory:

Net additions to or reductions of capital returnable through depreciation. (See note 1 below.)

Depreciation actually written off during the year (whether credited to the asset or set up in a reserve). (See note 1 below.)

Balance returnable through depreciation at the end of the taxable year.

207. Note 1.—See Regulations 45, article 840 (1) and (2). If any increase of capital assets is entered, under the conditions of the above article, the increase should be shown as an addition for the proper year. An explanation should be attached the nature of each increase resulting from an addition to capital account such as an amount which had previously been charged off as operating expense or as excessive depreciation, such as a purchase of new equipment, or such as a replacement of old equipment. Each decrease of capital account through loss, sale, or otherwise should be explained. If both an addition and a reduction apply to the same item in the same year, an explanation as outlined above should be made for each. State what the taxpayer's policy has been with regard to differentiating between addition to capital and maintenance expense.

208. Note 2.—Where an amount different from that stated under (g) is stated under (h), make a full statement of the reasons for the differences. Explain and justify the value stated under (h), showing any increase in value due to appreciation separate from that which is a result of returning to capital accounts amounts which have previously been charged off as operating expenses.

209. Note 3.—See Regulations 45, article 163. Where depreciation is claimed under 206 (class 5) a statement will be made showing fully the facts upon which the claim is based.

210. Note 4.—In the case of a very old plant or equipment for which the taxpayer's records contain incomplete data, just as much as possible of the data indicated above should be given. In the case of 201 (c) above for each item included in the inventory state whether the estimated life is based (1) on the period during which timber will be available, or (2) on the period during which the item of physical property will remain in a usable condition.

ADDITIONAL TIMBER IN BLOCK

211. Frequently there is additional timber within the exterior boundaries of the blocks described under "timberland" or so located that if it were owned by the taxpayer it would logically be added to one of his blocks. If there is such timber which is not definitely destined to be cut by some other operator and if the taxpayer answering this questionnaire will in all probability secure the timber, give the following data for such additional timber with respect to each block:

Approximate additional area, ... acres.
Approximate additional total quantity of timber,........................
(Unit.)

The above data are needed in connection with the estimation of the probable life of the operation.

OPERATION

RAW MATERIAL HANDLED

212. For each manufacturing operation state the quantities of raw material handled during each of the years indicated. State the unit of measure, as,

thousand feet log scale, cords, thousand linear feet, etc. The unit of measure should be that used in the woods. State what scale rule was used. Use a table similar to the following:

Note.—A separate table should be made for each different sort of product.

Product Unit of measure (M feet log scale, cords, M linear feet, etc.) Describe unit of measure	Quantities.						
	1912	1913	1914	1915	1916	1917	1918
Debits.							
213. Inventory at beginning of year							
214. Material cut in woods by taxpayer							
215. Material purchased							
216. Inventory adjustments (see note 1)							
217. Total debits							
Credits.							
218. Sold to other operators							
219. Losses (see note 2)							
220. Inventory adjustments (see note 1)							
221. Inventory at end of year							
222. Total credits							
223. Quantity used during year							
217 equals 213 plus 214 plus 215 plus 216. 222 equals 218 plus 219 plus 220 plus 221. 223 equals 217 minus 222.							

224. Note 1.—Enter the correction for ascertained errors in the inventory for the previous year; if the quantity was understated, enter under "debits"; if overstated, enter under "credits."

225. Note 2.—Include only those losses in quantity due to sinkage, breakage, boomage, etc., sustained in handling from stump to manufacturing plant, or to point of sale, as the case may be.

226. Note 3.—In those cases in which the inventory of raw material is substantially the same from year to year and in which it is the recognized custom to disregard inventories of raw material, (213), (216), (220), and (221) need not be filled in.

FINISHED PRODUCTS HANDLED

227. For each manufacturing operation state the quantity of lumber cut and the quantity of lumber sold in thousand feet board measure, lumber tally, for the years indicated, using a table similar to the following. Prepare also a separate similar table for each product not measured in feet board measure, lumber tally.

Note.—Do not enter costs or values.

Unit of measure	Quantities.						
	1912	1913	1914	1915	1916	1917	1918
Debits.							
228. Lumber inventory at beginning of year							
229. Inventory adjustments (increase)							
230. Purchases of lumber							
231. Total of lines 228, 229, and 230							
Credits.							
232. Lumber inventory at end of year							
233. Inventory adjustments (decrease)							
234. Sales of lumber plus lumber used							
235. Losses of lumber							
236. Total of lines 232, 233, 234, and 235							
237. Lumber cut during year (236 minus 231)							
238. Logs sawed during year (same as 228) (State in terms of log scale.)							
239. Over run or under run: Quantity of lumber cut (lumber tally) over or under logs sawed, log scale							
240. Over run or under run, per cent							

LUMBER INVENTORY

241. For each manufacturing operation give such of the following data as are disclosed by the taxpayer's records: Quantity of lumber shown by inventory, in feet board measure, to be on hand on the last day of each taxable year.

Taxable year.	Total.	Enter name of species in these columns.					Miscellaneous species.
1912							
1913							
1914							
1915							
1916							
1917							
1918							

SHIFTS OPERATED AND CAPACITY

242. Is the taxpayer's sawmill (or sawmills) equipped to operate a night shift in addition to the day shift? ....
(Yes or no.)

243. What total number of shifts did the sawmill operate in each of the years indicated? What was the average cut per shift? What was the average number of hours in each shift?

Year.	Total number of shifts operated.	Average cut in feet board measure, lumber tally, per shift for the year.	Average number of hours in each shift.
1912			
1913			
1914			
1915			
1916			
1917			
1918			

If the taxpayer operates more than one sawmill plant, a table similar to the above should be prepared for each.

244. With the climatic conditions under which the taxpayer operates, what is considered the average maximum of shifts per year which it is practicable to operate a sawmill?

CHARACTER OF MILL PLANT IN 1918

Sawmill.

245. Number of headsaws, ...; bands, ...; circulars, ...
246. Resaws, including gang saws: number, ...; kind, ...

Dry Kilns.

247. Number ....
248. Daily capacity, ...
(State unit.)
249. Per cent of total output kiln dried, ...

Planing Mill.

250. Number of machines, ...
251. Per cent of total output planed, ...
252. In a similar manner describe briefly other remanufacturing plants, if any are owned by the taxpayer, also any supplementary plants such as shingle mills, stave mills, etc. If the taxpayer operates more than one sawmill plant, the information from 245 to 252, inclusive, should be furnished for each.

PROFIT OR LOSS FROM SALE OF CAPITAL ASSETS

With respect to each transaction involving the sale of timber or land or both during the period from March 1, 1913, to the end of the taxable year of 1918, furnish the following information:

Note.—Where a transaction involving the sale of timber or land or both includes also other sorts of property, give the information called for in questions 279 to 287, inclusive, separately for timberland, for physical property, and for any other classes of property

253. Description of property (describe by legal subdivisions, if possible; if this can not be done, be as definite as practicable).

Note.—With respect to each sale of property described in 25 to 81, inclusive, answers to questions 254 to 278, inclusive, may be omitted. For such sales the transaction at this point should be carefully identified with the case described in 25 to 81, inclusive.

254. Total area, ... acres.
255. Area of merchantable timber, ... acres.
256. Area of young timber too small to be cut for a useful purpose, ... acres.
257. Area of all other sorts of land, ... acres.

For area 255 above, give the information indicated in 258, 259, and 260.

258. Total estimated quantity of timber, ...
(Unit.)

259. State the per cent of each species of timber, based on units of volume, present in each classification of 258. If any dead timber is included in the estimate, state what per cent of the total timber is dead; state in per cent of the total dead timber how the dead timber is distributed in the different species. If the taxpayer has incomplete information with respect to the per cent of each species, give such information as he has, as, for example, the per cent of each of a few leading species with others lumped, or the per cent of hard woods and the per cent of soft woods, etc.

260. So far as the taxpayer has the information, describe the important tree species with reference to size and quality by some means such as: the average number of logs per tree or the merchantable length; the average number of logs per 1,000 feet, board measure, log scale; per cent of volume in different recognized log grades; per cent of defect, etc. This information is intended to bring out as clearly as possible the character and condition of the timber on account of its effect upon value.

261. For area 256 above, describe the young timber as clearly as possible

with reference to the proportion of the species of trees present, the average size of the trees, etc.

262. Describe any other property involved in the transaction..............
....

263. Date of disposal of property ....

264. Manner of disposal of the property (sale, trade, gift, etc.) ....

265. Amount received in cash, $...........

266. Amount received in stock, $...........

267. Par value of stock, $...........

268. Actual cash value of stock, $...........

269. How was this cash value established?

270. Amount received in bonds, $...........

271. Par value of bonds, $...........

272. Actual cash value of bonds, $...........

273. How was this cash value established?

274. Amount received in other considerations, $...........

275. What were these considerations?

276. Actual cash value of these considerations, $...........

277. Manner of determining this cash value.

278. Give the name and address of the party determining this value, and state his connection, direct or indirect, if any, with the taxpayer.

279. Total cash value of all cash, stocks, bonds, and other considerations received for property, $...........

SUMMARY

280. Value of property as of March 1, 1913, or its cost if acquired subsequent to that date, $...........

281. Total of all additions to capital returnable through *depletion* added subsequent to March 1, 1913, or subsequent to date of acquisition if property acquired subsequent to March 1, 1913, $.............

282. Total of all additions to capital returnable through *depreciation* added subsequent to March 1, 1913, or subsequent to date of acquisition if acquired subsequent to March 1, 1913, $...........

283. Gross value of property as of date of disposition (total of 280, 281, and 282), $...........

284. Total *depletion* sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property, $...........

285. Total *depreciation* sustained during period from March 1, 1913, or from date of acquisition, if acquired subsequent to March 1, 1913, to date of disposition of property, $...........

286. Net value of property as of date of disposition (283 less the sum of 284 and 285), $...........

287. Profit or loss sustained from disposition of property (difference between 279 and 286), $...........

MISCELLANEOUS

LITIGATIONS

288. Give a list of litigations with respect to the property of the taxpayer occurring between January 1, 1911, and January 1, 1915, so far as such litigations involved the value of the property.

TRANSACTIONS WITH AFFILIATED CORPORATIONS

289. If, in any of the transactions described herein, any person, partnership, or corporation was mutually interested to the extent of 50 per cent or more in the ownership of the taxpayer and in the ownership of the other party to the transaction, list each of such transactions, and describe the relationship as to ownership. (See Regulations 45, articles 205 and 633.) Similarly report leases in which affiliated persons, partnerships, or corporations are or were mutually interested.

JURAT

290. I swear (or affirm) that the answers to the questions herein, including statements and figures entered in the accompanying schedules and in any additional statements and schedules attached hereto are to my best knowledge and belief, true and correct in each and every particular.

....
(Signature of individual or agent.)

Sworn to and subscribed before me this .... day of ...., ...
(Month.) (Year.)

[SEAL.] ....
(Signature.)

....
(Title.)

291. We, the undersigned, general officers of..................................
(Name of corporation,
....
partnership, or association.)
being severally duly sworn, each for himself deposes and says that the answers to the questions herein, including statements and figures entered in the accompanying schedules and in any additional statements and schedules attached hereto, are, to his best knowledge and belief, true and correct in each and every particular.

....
(Signature.)

....
(State title.)

....
(Signature.)

....
(State title.)

Sworn to and subscribed before me this .... day of ...., ...
(Month.) (Year.)

[SEAL.] ....
(Signature.)

....
(Title.)

ILLUSTRATIONS OF COMPUTATIONS OF THE WAR-PROFITS AND EXCESS-PROFITS TAXES.

No. 1. Illustration of Ordinary Computation of Tax.—A corporation has an average prewar invested capital at $50,000, an average prewar net income of $10,000, an invested capital for 1918 of $100,000, a net income for 1918 of $40,000, an invested capital for 1919 of $110,000 and a net income of $50,000.

(1) For 1918 the excess-profits credit is a specific exemption of $3,000, plus 8 per cent of the invested capital (i. e., 8 per cent of $100,000) or $8,000, making a total of $11,000. The war profits credit is a specific exemption of $3,000, plus the average prewar net income or $10,000, plus or minus 10 per cent of the difference between the average prewar invested capital and the invested capital for 1918. In this case it is plus, because the invested capital for 1918 is greater than the average prewar invested capital. The amount added is 10 per cent of the difference between $100,000 and $50,000, i. e., 10 per cent of $50,000, or $5,000, making a total war-profits credit of $18,000.

First Bracket.—The amount or portion of the net income ($40,000) in excess of the excess-profits credit ($11,000) and not in excess of 20 per cent of the invested capital (i e., 20 per cent of $100,000) or $20,000 is $9,000. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $9,000) or $2,700.

Second Bracket.—The amount or portion of the net income ($40,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $100,000) or $20,000 is $20,000. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $20,000) or $13,000.

Third Bracket.—Eighty per cent of the amount or portion of the net income in excess of the war-profits credit (i. e., 80 per cent of the amount by which $40,000 exceeds $18,000, or $22,000) is $17,600. The amount of the tax computed under the first and second brackets ($2,700 plus $13,000) is $15,700. The tax computed under this bracket is the amount by which $17,600 exceeds $15,700, or $1,900.

Total Tax.—The total tax for 1918 is the sum of the taxes computed under the three brackets (i. e., $2,700 plus $13,000 plus $1,900) or $17,600.

(2) For 1919 the excess-profits credit is a specific exemption of $3,000 plus 8 per cent of the invested capital (i. e., 8 per cent of $110,000) or $8,800, a total of $11,800.

First Bracket.—The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($11,800) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000) or $22,000 is $10,200. The tax computed under this bracket is 20 per cent of this amount (i. e., 20 per cent of $10,200) or $2,040.

Second Bracket.—The amount or portion of the net income ($50,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000) or $22,000 is $28,000. The tax computed under this bracket is 40 per cent of this amount (i. e., 40 per cent of $28,000) or $11,200.

Total Tax.—The total tax for 1919 is the sum of the taxes computed under the two bracket (i. e., $2,040 plus $11,200) or $13,240.

No. 2. Illustration of Computation Where No Tax Under Third Bracket.—If the corporation used in the foregoing illustration had an average prewar net income of $20,000 instead of $10,000, the excess-profits credit and the tax for 1918 computed under the first and second brackets would be the same, but the war-profits credit and the tax computed under the third bracket would not be the same. The war-profits credit would be a specific exemption of $3,000 plus the average prewar net income or $20,000, plus 10 per cent of $50,000 (the difference in invested capital) or $5,000, making a total war-profits credit of $28,000.

Third Bracket.—Eighty per cent of the amount of the net income in excess of the war profits (i. e., 80 per cent of the amount by which $40,000 exceeds $28,000 or 80 per cent of $12,000) is $9,600. The amount of the tax computed under the first and second brackets ($2,700 plus $13,000) is $15,700. There is accordingly no tax under the third bracket, as $9,600 does not exceed $15,700.

Total Tax.—The total tax for 1918 is the sum of the taxes computed under the three brackets (i. e., $2,700 plus $13,000 plus nothing) or $15,700. The total tax of 1919 would, of course, be the same as in the foregoing illustration.

No. 3. Illustration of Computation Where Excess-Profits Credit Not Exhausted Under First Bracket.—A corporation has an average prewar invested capital of $20,000, an average prewar net income of $7,000, and invested capital and net income for 1918 of the same amounts, respectively. The excess-profits credit is a specific exemption of $3,000 plus 8 per cent of the invested capital (i. e., 8 per cent of $20,000) or $1,600, a total of $4,600. The war-profits credit is a specific exemption of $3,000 plus the average prewar net income of $7,000, a total of $10,000. There is nothing further to be added or deducted in this case, as there is no difference between the average invested capital for the prewar period and invested capital for the taxable year.

First Bracket.—The excess-profits credit ($4,600) exceeds 20 per cent of the invested capital (20 per cent of $20,000) or $4,000, and there is no amount taxable under this bracket.

Second Bracket.—The portion of the net income ($7,000) in excess of 20 per cent of the invested capital (20 per cent of $20,000) or $4,000 is $3,000. In this case, however, the full amount of the excess-profits credit could not be allowed under the first bracket, so that the $3,000 which would ordinarily be taxable under this bracket is reduced by the amount of the excess-profits credit not allowed under the first bracket ($600), leaving only $2,400 taxable under this bracket. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $2,400) or $1,560.

Third Bracket.—The war-profits credit ($10,000) exceeds the net income ($7,000), so that there is no tax under this bracket.

Total Tax.—The total tax for 1918 would be the sum of the taxes com-

puted under the three brackets (i. e., nothing plus $1,560 plus nothing) or $1,560, were it not that Section 302 provides that the maximum tax shall not in this case exceed $1,200. The total tax for 1918 is therefore $1,200. (See illustration No. 10.)

No. 4. Illustration of Computation Where Net Income Derived from Government Contract.—If in the case used in illustration No. 1 the $50,000 net income for 1919 includes $20,000 of net income from Government contracts, the tax for that year would be the sum of the amounts computed under clauses (1) and (2) of Section 301 (c) of the statute.

(1) Under clause (1) the excess-profits credit is $11,800, the same as under clause (2). The war-profits credit is a specific exemption of $3,000, plus the average prewar net income, or $10,000, plus 10 per cent of $50,000 (the difference in invested capital) or $6,000, making a total war-profits credit of $19,000.

First Bracket.—The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($11,800) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000), or $22,000, is $10,200. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $10,200) or $3,060.

Second Bracket.—The amount or portion of the net income ($50,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000) or $22,000, is $28,000. The tax computed under this bracket is 65 per cent of this amount (65 per cent of $28,000) or $18,200.

Third Bracket.—Eighty per cent of the amount of the net income in excess of the war-profits credit (i. e., 80 per cent of the amount by which $50,000 exceeds $19,000, or $31,000) is $24,800. The amount of the tax computed under the first and second brackets ($3,060 plus $18,200) is $21,260. The tax computed under this bracket is the amount by which $24,800 exceeds $21,260, or $3,540.

The portion of the tax computed under clause (1) is the same proportion of the total amount computed under the above brackets at the rates for 1918 (i. e., $3,060 plus $18,200 plus $3,540) or $24,800, as the part of the net income attributable to Government contracts ($20,000) is of the entire net income $50,000). This portion of the tax is therefore 2/5 of $24,800 or $9,920.

(2) The portion of the tax computed under clause (2) is the same proportion of the total amount computed at the rates for 1919 or $13,240 (for the details see computation for 1919 in illustration No. 1 above) as the part of the net income not attributable to Government contracts ($30,000) is of the entire net income ($50,000). This portion of the tax is therefore 3/5 of $13,240 or $7,944.

(3) The total tax for the year 1919 is the sum of the amounts computed under paragraphs (1) and (2) above ($9,920 plus $7,944) or $17,864.

No. 5. Illustration of Computation of Tax Where Net Income Is Partly from Personal Service Business.—A corporation is engaged in contracting and construction work (a non-personal service business in which the employment of capital is necessary) and also renders consulting engineering service (a personal service business which if constituting its sole business would bring

it within the class of personal service corporations). It has an average pre-war invested capital of $50,000 (of which $38,000 was used in contracting work and $12,000 in engineering); an average prewar net income of $52,000 (of which $12,000 was derived from contracting and $40,000 from engineering); invested capital for 1918 of $100,000 (of which $81,000 is used in contracting and $19,000 in engineering); and a net income for 1918 of $90,000 (of which $30,000 is derived from contracting and $60,000 from engineering).

(1) In computing the tax upon the first or non-personal-service part of the net income (i. e., $30,000 derived from contracting) the specific exemption is $1,000 (i. e., the same proportion of $3,000 which $30,000 is of the entire net income of $90,000). The excess-profits credit is a specific exemption of $1,000 plus 8 per cent of the invested capital used in contracting (i. e., 8 per cent of $81,000) or $6,480, a total of $7,480. The war-profits credit is a specific exemption of $1,000, plus the average prewar net income derived from contracting or $12,000, plus 10 per cent of $43,000 (the difference in invested capital used in contracting) or $4,300, making a total of $17,300.

First Bracket.—The amount of the net income derived from contracting ($30,000) in excess of the excess-profits credit ($7,480) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $81,000) or $16,200 is $8,720. The tax under this bracket is 30 per cent of this amount (i. e., 30 per cent of $8,720) or $2,616.

Second Bracket.—The amount of the net income derived from contracting ($30,000) in excess of 20 per cent of the invested capital used in contracting (i. e., 20 per cent of $81,000) or $16,200 is $13,800. The tax computed under this bracket is 65 per cent of this amount (65 per cent of $13,800) or $8,970.

Third Bracket.—Eighty per cent of the amount of the net income derived from contracting in excess of the war-profits credit (i. e., 80 per cent of the amount by which $30,000 exceeds $17,300 or 80 per cent of $12,700) is $10,160. The amount of the tax computed under the first and second brackets ($2,616 plus $8,970) is $11,586. There is no tax under this bracket, as $10,160 does not exceed $11,586.

Tax.—The tax upon the first portion of the net income (i. e., $30,000 derived from contracting) is the sum of the taxes computed under the three brackets (i. e., $2,616 plus $8,970 plus nothing) or $11,586. This is 38.62 per cent of $30,000 of the net income from contracting.

(2) The tax upon the second or personal service part of the net income (i. e., $60,000 derived from engineering is the same percentage of such part of the net income (i. e., 38.62 per cent of $60,000) or $23,172.

(3) The total tax is the sum of $11,586 (the tax upon the first part of the net income derived from contracting) and $23,172 (the tax upon the second part of the net income derived from engineering) or $34,758.

No. 6. Illustration of Computation of Tax Where Net Income Is from Gold Mining.—In the case used in illustration No. 1, assume the corporation is engaged in the mining both of gold and of other rare metals; that the Commissioner finds that $35,000 of its gross income is properly attributable to the mining of gold; and that $20,000 of the deductions allowed are properly applicable to the gross income from that source. The portion of the net income attributable to the mining of gold and exempt from tax would be $15,000.

The remaining portion of the net income is $25,000 and the tax thereon is the same proportion of the tax computed on the entire net income without the benefit of the exemption (i. e., a tax of $17,600) which the remaining portion of the net income ($25,000) bears to the entire net income ($40,000). The tax will therefore be 5/8 of the tax of $17,600 computed without the benefit of the exemption, or $11,000.

No. 7. Illustration of Computation of Tax Where Income from Sale of Mineral Deposits.—In the case used in illustration No. 1, assume the gross income of the corporation for 1918 included $15,000 derived from a bona fide sale of an oil well, the principal value of which had been demonstrated by exploration and discovery work done by the corporation, and that the Commissioner finds that only $800 of the deductions allowed are properly applicable to the gross income derived from the sale. The portion of the net income attributable to the sale would be $14,200, which is 35.5 per cent of the entire net income of $40,000, and the portion of the tax for that year attributable to the sale will be 35.5 per cent of the entire tax of $17,600, or $6,248. But this portion of the tax can not exceed 20 per cent of the selling price ($15,000) and is accordingly reduced to $3,000. The total tax will be $11,352 (the portion of the tax not affected) plus $3,000, or $14,352 (instead of $17,600).

No. 8. Illustration of Consumption of Tax for Fiscal Year.—A corporation makes its return on the basis of a fiscal year ending March 31. It had an average prewar invested capital of $50,000 and an average prewar net income of $3,500. For the fiscal year ending March 31, 1918, its invested capital and net income are $100,000 and $75,000, respectively, as computed under Title II of the Revenue Act of 1917, and $125,000 and $70,000, respectively, as computed under the present statute. Such a difference in these amounts as computed under the two acts may readily occur where, for example, a corporation is allowed under the present statute a deduction for interest, amortization, etc., which it was not allowed under the Revenue Act of 1917, or where, under the present statute, it is allowed a greater amount of invested capital on account of intangible property paid in for stock or shares than allowed under the Revenue Act of 1917. For the fiscal year ending March 31, 1919, its invested capital and net income are $125,000 and $60,000, respectively.

(1) A war excess-profits tax for the year ending March 31, 1918, as computed under the provisions of Title II of the Revenue Act of 1917, and upon the basis of an invested capital of $100,000 and a net income of $75,000 as computed under that Act, is $32,800. For the details of this computation see illustration (1) under article 16 of Regulations 41. A war-profits and excess-profits tax for the entire period as computed under subdivision (a) of section 301 of the present statute, and upon the basis of an invested capital of $125,000 and a net income of $70,000 as computed under the statute, is $43,600. Section 335 provides that the tax for this period is the sum of 9/12 of the tax of $32,800 as computed under the Revenue Act of 1917, or $24,600, plus 3/12 of the tax of $43,600 as computed under the present statute, or $10,900, making a total war excess-profits tax for the fiscal year ending March 31, 1918, of $35,500.

(2) A war-profits and excess-profits tax for the year ending March 31, 1919, as computed under subdivision (a) of section 301 of the statute is $35,600. A war-profits and excess-profits tax for the entire period as computed under subdivision (b) of section 301 is $16,400. Section 335 provides that the tax for this period is the sum of 9/12 of the tax of $35,600, as computed under subdivision (a) of section 301, or $26,700, plus 3/12 of the tax of $16,400, as computed under subdivision (b) of section 301, or $4,100, making a total war-profits and excess-profits tax for the fiscal year ending March 31, 1919, of $30,800.

No. 9. Illustration of Computation Where Return for Period of Less Than 12 Months.—A corporation which has reported on the basis of the fiscal year ending March 31, 1918, later changes to a calendar year basis and files a return covering the 9 months from April 1, 1918, to December 31, 1918. It had an average prewar capital of $50,000, an average prewar net income of $3,500, an invested capital for the 9 months ending December 31, 1918, of $120,000, and a net income for such period of $50,000. The computation in this illustration follows the directions contained in return form 1120 and proportionately reduces items 3 and 8 of schedule III and items 1 and 2 of column 2 of schedule IV. It should be noted that this is a somewhat different method of arriving at the same result which would be reached under a literal application of sections 305, 311 (a) (2) and 326 (d) of the statute. The excess-profits credit is computed by adding the specific exemption of $3,000 to 8 per cent of the full invested capital of $120,000 or $9,600, a total of $12,600, and taking 9/12 of this result, or $9,450, as the excess-profits credit. See item 3 of schedule III of form 1120. The war-profits credit is computed by adding the specific exemption of $3,000 to 10 per cent of the full invested capital of $120,000, or $12,000, a total of $15,000, and taking 9/12 of this result, or $11,250, as the war-profits credit. See item 8, of schedule III of form 1120. The war-profits credit is computed in this case under section 311 (b), because the amount computed under section 311 (a) (2) is less than 10 per cent of the invested capital. The amount computed under section 311 (a) (2) would be the sum of the average prewar net income, or $3,500, plus 10 per cent of the amount by which the full invested capital of $120,000 actually used during the taxable period exceeds the average prewar invested capital of $50,000 (i. e., 10 per cent of $70,000), or $7,000, a total of $10,500. See items 4 and 5 of schedule III of form 1120. This amount is less than 10 per cent of the full invested capital for the taxable year as computed under section 311 (b). See item 6 of schedule III of form 1120.

First Bracket.—The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($9,450) and not in excess of 9/12 of 20 per cent of the invested capital (i. e., 9/12 of 20 per cent of $120,000), or $18,000, is $8,550. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $8,550), or $2,565.

Second Bracket.—The amount or portion of the net income ($50,000) in excess of 9/12 of 20 per cent of the invested capital (i. e., 9/12 of 20 per cent of $120,000), or $18,000, is $32,000. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $32,000), or $20,800.

Third Bracket.—80 per cent of the amount or portion of the net income in

excess of the war-profits credit (i. e., 80 per cent of the amount by which $50,000 exceeds $11,250, or $38,750), is $31,000. The amount of the tax computed under the first and second brackets ($2,565 plus $20,800) is $23,365. The tax computed under this bracket is the amount by which $31,000 exceeds $23,365, or $7,635.

Total Tax.—The total tax will be the sum of the taxes computed under the three brackets (i. e., $2,565 plus $20,800 plus $7,635) or $31,000.

No. 10. Illustration of Computation of Limitation.—If in illustration No. 9 the invested capital had been $100,000 and the net income $80,000, the tax computed under section 301 (a) of the statute would be $56,200. Section 302 provides, however, that the tax under section 301 (a) shall not be more than 30 per cent of the net income in excess of $3,000 and not in excess of $20,000 plus 80 per cent of the net income in excess of $20,000. In this case the return is for three-fourths of a year and the $3,000 and $20,000 are reduced to $2,250 and $15,000 respectively. The tax is therefore 30 per cent of $12,750 (the difference between $2,250 and $15,000), plus 80 per cent of $65,000 (the balance of the net income), a total of $55,825. The tax under section 301 (a), amounting to $56,200, will accordingly be reduced to $55,825.

AVERAGE PERCENTAGES OF PRE-WAR INCOME TO PRE-WAR INVESTED CAPITAL OF GENERAL CLASSES OF CORPORATIONS, GROUPED AS TO TRADES OR BUSINESSES, AS PROVIDED FOR IN SECTION 311 (C) (2) REVENUE ACT OF 1918.

SCHEDULE OF AVERAGE PERCENTAGES

Section 311 of the Revenue Act of 1918 provides that a corporation which was not in existence during the whole of at least one calendar year during the prewar period, and therefore received no income during the prewar period, shall be allowed a specific exemption of $3,000 and "an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average percentage shall be determined by the Commissioner on the basis of data contained in returns made under Title II of the Revenue Act of 1917, and the average known as the median shall be used."

In pursuance of this requirement of the law the accompanying table of medians has been compiled and will be used in complying with Section 250 (b), which provides, "As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of Section 252."

Inasmuch as the examination of all returns filed will not be completed by the due date of the last installment of 1918 taxes, it is suggested that the taxpayers entitled to credit based on the appropriate median shown in the accompanying tables, may recompute their tax using a war profits credit based on such median, and file claim for abatement for as much of the last installment of the outstanding assessment as the total tax assessed exceeds the tax so recomputed. In any case where the amount already paid exceeds the amount due, with the benefit of the median, claim for refund should also be filed on Form 46.

AGRICULTURE AND DEPENDENT PURSUITS

Subdivisions	Average Percentages Per Cent
1. Cotton ginning	11.73
2. Cotton growing	Not over 10.
3. Dairying and dependent pursuits, including butter, cheese, and condensed milk	" " 10.
4. Fisheries	" " 10.
5. Florists, nurserymen, and seedmen	" " 10.
6. Forestry and forestal pursuits, naval stores, charcoal burning and grinding	13.
7. Fruit and vegetable growing, including vineyards, orchards, and trucking	Not over 10.
8. Grain growing	" " 10.
9. Poultry raising and products	" " 10.
10. Mixed farming, including stock breeding, stock raising and general animal husbandry. Agricultural pursuits not elsewhere specified	" " 10.

MINING

Subdivisions	Average Percentages Per Cent
1. Cinnabar	Not over 10.
2. Clay	" " 10.
3. Coal, anthracite	" " 10.
4. Coal, bituminous	" " 10.
5. Copper	" " 10.
6. Gravel and sand	" " 10.
7. Gypsum	11.81
8. Iron	Not over 10.
9. Lead and zinc	" " 10.
10. Limestone	" " 10.
11. Natural Gas	" " 10.
12. Petroleum	" " 10.
13. Phosphate	" " 10.
14. Pipe lines	17.24
15. Salt	Not over 10.
16. Silver, complex ores	" " 10.
17. Talc and Soapstone	" " 10.

CHEMICAL MANUFACTURING AND ALLIED INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Baking powder, yeast	14.44
2. Blacking, bluing, whiting, stains and dressing, dyestuffs, extracts and coloring materials, inks (printing and writing), paints and varnishes	11.44

Subdivisions	Average Percentages Per Cent
3. Celluloid and products	Not over 10.
4. Cleansing and polishing preparations, soaps and washing compounds	10.56
5. Crude chemicals, including leading acids, fertilizers, etc.	Not over 10.
6. Druggist's preparations, including perfumery, cosmetics, and patent medicine compounds	10.98
7. Oils, vegetable and animal, including seed cake	Not over 10.
8. Petroleum refining, products and by-products	11.27
9. Chemicals, not elsewhere specified	Not over 10.

MANUFACTURING FOODS AND FOOD PREPARATIONS

Subdivisions	Average Percentages Per Cent
1. Bread and other bakery products, not including confectionery	11.26
2. Canning, preserving and evaporating-fruits, vegetables, fish, oysters and shrimps	10.67
3. Chocolate and cocoa products, candy and confectionery	Not over 10.
4. Coffee-roasting, grinding spices, and coffee substitutes	10.87
5. Flavoring extracts, syrups and cordials used in bottling industries	Not over 10.
6. Flour, feed and grist mills	" " 10.
7. Meat packing, packing house products and by-products	" " 10.
8. Oleomargarine and other butter and lard substitutes, including both animal and vegetable	12.45
9. Pickling establishments	Not over 10.
10. Rice mills, cleaning and polishing, not including rice flour	" " 10.
11. Special package foods, such as cornstarch, macaroni, tapioca, etc., breakfast foods and other cereal products	10.79
12. Sugar-beet, including refining, molasses recovery	Not over 10.
13. Sugar-cane, including molasses and syrup in bulk	" " 10.
14. Syrups and molasses-glucose and others, including maple	" " 10.
15. Vinegar and cider	" " 10.
16. Food preparations, not elsewhere specified	10.83

IRON AND STEEL INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Agricultural implements	Not over 10.
2. Automobiles and auto parts, including bicycles and motorcycles and parts. Motor trucks and motor truck parts	" " 10.
3. Blast furnace products	" " 10.
4. Boilers, evaporating pans, oil tanks, and silos	" " 10.

Subdivisions	Average Percentages Per Cent
5. Bolts and nuts, including washers and rivets	Not over 10.
6. Engines—steam, gas, and oil	" " 10.
7. Forging and foundry products, including castings, car wheels, and stoves	" " 10.
8. Hardware, special and general	" " 10.
9. Heating, cooling, and ventilating apparatus, including furnaces (no stoves), refrigerating plants, dust collecting systems	" " 10.
10. Machinery—electrical and other electrical apparatus	" " 10.
11. Machinery—excavating, cars and tools	" " 10.
12. Machinery—hoisting, cranes, derricks, and conveyors	" " 10.
13. Machinery—humidifying, air moistening, and air conditioning	" " 10.
14. Machinery—laundry	" " 10.
15. Machinery—mill, neither textile nor woodworking	" " 10.
16. Machinery—mining	" " 10.
17. Machinery—printing and duplicating	" " 10.
18. Machinery—saw mill	Not over 10.
19. Machinery—textile, also parts	" " 10.42
20. Machinery—woodworking	" " 10.
21. Machines—adding and calculating	" " 10.
22. Machines—check-writing, slot, testing, vending, weighing, including addressographs, balances, scales, registering devices, and watchman's clocks	" " 10.
23. Machines—sewing	" " 10.
24. Meters—gas, water, etc.	" " 10.
25. Plumbing supplies, including gas and water apparatus, porcelain wares for kitchen and laundry	" " 10.
26. Pumps	" " 10.
27. Railway equipment, including locomotives, street railway, mining, and industrial cars	" " 10.
28. Safes and vaults	" " 10.
29. Shipbuilding	" " 10.
30. Steel plants and rolling mill products, including tin and terne plate mill products, iron and steel chains, steel doors and shutters	" " 10.
31. Structural steel	" " 10.
32. Tin cans and tin ware	" " 10.
33. Tools—farm, garden, machine, mechanics, mining, lumbering, railroad track repairing, including bench lathes, shears and saws	" " 10.
34. Tractors—farm and highway	" " 10.
35. Typewriters and typesetting machinery	" " 10.
36. Wire cables, fences, springs, nails and spikes	" " 10.24
37. Iron and steel products not elsewhere specified	Not over 10.

LEATHER AND LEATHER GOODS INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Boots and shoes	10.94
2. Leather manufacture	10.69
3. Leather substitutes	11.82
4. Leather articles other than boots and shoes	Not over 10.

LIQUORS AND BEVERAGES

Subdivisions	Average Percentages Per Cent
1. Bottling of liquors and soft drinks as distinct from manufacturing	Not over 10.
2. Distillers of whiskies and spirits, refining and rectifying of liquors and beverages	" " 10.
3. Malt liquors (brewers)	" " 10.
4. Wines	" " 10.
5. Non-intoxicating beverages—cocoa-cola and other special drinks, mineral, soda, and aerated waters, including bottled tonic drinks, soft drinks, spring waters, malting grains, all others not elsewhere specified	" " 10.

LUMBER AND WOODWORKING INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Box boards, baskets, cases	Not over 10.
2. Caskets, coffins, burial cases of wood, not including steel or concrete	" " 10.
3. Furniture, all classes, including veneering, chair seating..	" " 10.
4. Mills—shingle, lath	" " 10.
5. Paper pulp and pulp board	" " 10.
6. Planing mills, flooring, sash, doors, partitions and interior work generally	" " 10.
7. Ready-made houses	" " 10.
8. Silos and silo materials, cooperage stock, tanks, not including steel or concrete	" " 10.
9. Timbering, logging and saw mill operations	" " 10.
10. Wagons and buggies	" " 10.
11. Wood fibres, leatheroid, wood composition in other commodities	" " 10.
12. Woodworking industries, not elsewhere specified	" " 10.

METAL AND METALLURGICAL EXTRACTIONS

Subdivisions	Average Percentages Per Cent
1. Brass, bronze, copper and aluminum products	Not over 10.
2. Clocks, watches, chronometers	" " 10.
3. Cooking utensils (other than copper), granite goods, etc.	" " 10.
4. Cutlery, scissors, razors	" " 10.
5. Galvanized materials, spouting, gutters, metal roofing	" " 10.
6. Gas and electric fixtures	" " 10.
7. Jewelry	" " 10.
8. Lamps and accessories	" " 10.
9. Lead products	" " 10.
10. Needles, pins, metal hair pins, and pen points	15.54
11. Plate ware, electroplate, etc.	Not over 10.
12. Professional and scientific instruments, including dental supplies, and optical goods, surgical and hospital appliances, photographic apparatus and materials	10.50
13. Silverware and goldware, other than jewelry	Not over 10.
14. Smelting and refining—copper, lead, zinc, etc.	" " 10.
15. Metal and metallurgical industries, not elsewhere specified	" " 10.

PAPER MANUFACTURING, PRINTING, BOOKBINDING, PUBLISHING

Subdivisions	Average Percentages Per Cent
1. Blank paper	Not over 10.
2. Book and job printing, lithographing, including bank note and bond printing, labels, tags, and decorative paper	" " 10.
3. Book binding and blank book making	" " 10.
4. Cardboard, box materials, and box manufacture	10.48
5. Envelopes	10.28
6. Paper utensils	Not over 10.
7. Photo-engraving and printing processes	" " 10.
8. Printing materials	" " 10.
9. Publishing newspapers and other periodicals	" " 10.
10. Type founding, stereotyping and electrotyping	13.17
11. Wall paper	Not over 10.
12. Wrapping paper	" " 10.
13. Paper and printing, not elsewhere specified	" " 10.

STONE, CLAY, AND GLASS INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Abrasive products, including emery wheels, sand paper and corundum	12.72
2. Building brick, sewer and drainage pipe, fire brick, furnace linings, pottery, terra cotta, crucibles, tiling, laundry tubs, refractories, and earthenware	Not over 10.
3. Cement	" " 10.
4. Concrete construction, including artificial stone	" " 10.
5. Glassware, including household, hotel, and bar room supplies, X-ray tubes, thermos bottles, mirrors, refractors, illuminating glass, etc.	" " 10.
6. Glass—window, wire, and skylight	" " 10.
7. Lime and plaster	" " 10.
8. Monuments, tombstones, burial vaults	" " 10.
9. Porcelain goods and ceramic products, not elsewhere specified	" " 10.

TEXTILE INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Awnings, tents, tarpaulins, etc.	11.88
2. Bags and bagging-cotton and burlap	17.34
3. Batting mills	Not over 10.
4. Carpets and rugs, including cotton, wool, and grass	" " 10.
5. Clothing—men's, overcoats, suits, etc.	" " 10.
6. Clothing—ladies', coats, suits, and dresses	" " 10.
7. Clothing—miscellaneous, uniforms, furriers, regalia, belts, garters, etc.	" " 10.
8. Corsets and brassiers	19.90
9. Cotton converters, dyers, finishers, mercerizers, bleachers, and prints	Not over 10.
10. Cotton duck	11.90
11. Cotton goods manufacturing—colored, fancy, grey, brown, print cloth, and sheeting	Not over 10.
12. Cotton laces, curtains, quilts, embroideries	" " 10.
13. Cotton spinning—fine yarns	10.17
14. Cotton spinning—medium and coarse yarns	Not over 10.
15. Dyers of fur	11.97
16. Hats, caps, scarfs, and other headwear and neckwear	Not over 10.
17. Hosiery and knit goods, including knitted and fabric underwear	" " 10.
18. Millinery and millinery goods	" " 10.
19. Rope and cordage	Not over 10.
20. Shirts, collars and cuffs	" " 10.

Subdivisions	Average Percentages Per Cent
21. Silk-dyeing and finishing	12.10
22. Silk manufacturing—broad	Not over 10.
23. Silk manufacturing—ribbons, woven labels	" " 10.
24. Silk—spinning	" " 10.
25. Silk—throwing	" " 10.
26. Thread, tapes and braids, cotton and silk	" " 10.
27. Towels, damask, handkerchiefs, (cotton and linen)	" " 10.
28. Upholstery cloth and trimmings, (cotton and wool)	" " 10.
29. Waste—cotton and wool, linters and oakum	11.89
30. Wool and worsted—dyeing and finishing	Not over 10.
31. Wool and worsted—spinning and combing	" " 10.
32. Wool and worsted weaving	" " 10.
33. Textile manufacturing, not elsewhere specified	" " 10.

SPECIAL MANUFACTURING INDUSTRIES

Subdivisions	Average Percentages Per Cent
1. Ammunition, explosives and fireworks	11.28
2. Artificial flowers	Not over 10.
3. Artificial limbs	" " 10.
4. Asbestos wares, magnesia, material for insulation	16.88
5. Bedding, mattresses, and undertakers' supplies	Not over 10.
6. Brooms and brushes	" " 10.
7. Buttons, beads, rosaries	" " 10.
8. Coke	" " 10.
9. Combs—bone, ivory, etc.	" " 10.
10. Dairymen's, poultrymen's and apiarist's supplies	" " 10.
11. Fire extinguishers, including mechanical and chemical apparatus, automatic sprinklers, fire trucks	" " 10.
12. Hair goods	" " 10.
13. Hand stamps—rubber, metal, etc.	" " 10.
14. House furnishing goods, screen doors and windows, window shades	" " 10.
15. Ice	" " 10.
16. Jewelry and instrument cases	" " 10.
17. Models and patterns (not including paper patterns), molds	" " 10.
18. Mucilage and paste	11.23
19. Phonographs and all other musical instruments and parts (not including pianos, organs, and parts)	11.53
20. Pianos, organs and parts	Not over 10.
21. Roofing materials other than metal	" " 10.
22. Rubber—boots, shoes and clothing	" " 10.
23. Rubber—tires, belting, hose, tubing, including non-metalic conduits	" " 10.

Subdivisions	Average Percentages Per Cent
24. Rubber goods, not elsewhere specified	Not over 10.
25. Shipbuilding—wooden craft of all kinds	10.15
26. Signs and advertising novelties	14.45
27. Small metal specialties	Not over 10.
28. Soda fountain apparatus, siphons	15.20
29. Sporting and athletic goods (including pleasure boats, but not yachts), amusement appliances	Not over 10.
30. Stationery goods, school supplies, office system supplies	10.36
31. Stencil, dye sinking, seals	Not over 10.
32. Tobacco	12.87
33. Toys, children's tools and vehicles, including baby carriages, carts, games, and Christmas novelties	Not over 10.
34. Umbrellas and canes	Not over 10.
35. Washing machines and clothes wringers	12.22
36. Windmills	Not over 10.
37. Special products, not elsewhere specified	" " 10.

FINANCIAL—BANKS, INSURANCE COMPANIES, BROKERAGE INSTITUTIONS

Subdivisions	Average Percentages Per Cent
1. Banking—international	Not over 10.
2. Banking—private, money lenders, and pawnbrokers	" " 10.
3. Banking—savings	" " 10.
4. Banking—state and national	" " 10.
5. Banking—trust companies	" " 10.
6. Banking and financial operations, not elsewhere specified	" " 10.
7. Building and loan associations	" " 10.
8. Burglar alarm systems	" " 10.
9. Holding companies, incorporated estates, trusts, investment concerns	" " 10.
10. Insurance brokers	" " 10.
11. Insurance—fidelity and surety	" " 10.
12. Insurance—fire, mutual	" " 10.
13. Insurance—fire, stock	" " 10.
14. Insurance—life, mutual	" " 10.
15. Insurance—life, stock	" " 10.
16. Insurance—marine	" " 10.
17. Insurance—casualty, mutual	" " 10.
18. Insurance—casualty, stock	" " 10.
19. Insurance—title and abstract	" " 10.
20. Insurance—not elsewhere specified	" " 10.
21. Safe deposit vaults	" " 10.
22. Stock brokers and dealers in securities on commission	" " 10.

COMMON CARRIERS AND PUBLIC UTILITIES

Subdivisions	Average Percentages Per Cent
1. Cold storage and ice	Not over 10.
2. Cotton compressors and cotton storage	" " 10.
3. Gas companies, illuminating and fuel	" " 10.
4. Grain elevators	" " 10.
5. Irrigation water works	" " 10.
6. Light and power, including water and electric, hydro-electric lighting	" " 10.
7. Market houses—public	" " 10.
8. Railways—electric, city, suburban and interurban	" " 10.
9. Railway express companies	13.89
10. Railways—steam	Not over 10.
11. Steamships—local, river, lake, coastwise and ocean lines	" " 10.
12. Stock yards	" " 10.
13. Tank car companies, refrigerator, ventilator, and live stock cars	" " 10.
14. Telephone and telegraph companies	" " 10.
15. Warehouse and storage, other than cotton storage, wharves, forwarding, teaming, stevedoring, local express	" " 10.
16. Water filtration, distribution for domestic use	" " 10.
17. Common carriers and public utilities, not elsewhere specified. Toll bridge, bridge companies, ferry, turnpike, United Press Association, Passenger Bus Line, canals, etc.	" " 10.

TRADING AND MISCELLANEOUS

Subdivisions	Average Percentages Per Cent
1. Brokers—freight, grain, merchandise, real estate and ship, purchasing and selling agents, manufacturer's agents, exporters and importers (commission only), automobiles, sale of metals	Not over 10.
2. Garages and livery stables	" " 10.
3. Jobbers—merchandise, general and special	" " 10.
4. Merchant tailoring, needlework, etc.	17.14
5. Merchants—retail	Not over 10.
6. Merchants—wholesale	10.45
7. Real estate operators and promoters	Not over 10.
8. Trading concerns not elsewhere specified	" " 10.
9. Amusements, theaters, moving picture shows, county fairs, race tracks and clubs	" " 10.
10. Barbers, bathhouses, etc.	" " 10.
11. Consulting engineers, appraisers, accountants, adjusters, architects, chemists, assayers, and metallurgists	" " 10.

Subdivisions	Average Percentages Per Cent
12. Contractors, building construction, street paving, machine installation, etc.	" " 10.
13. Decorators and interior designing	" " 10.
14. Hospitals, sanitariums, etc.	" " 10.
15. Hotels	" " 10.
16. Laundries, dry cleaning, dyeing, etc.	" " 10.
17. Photographs and art portraits	19.66
18. Restaurants	Not over 10.
19. Schools, colleges, etc.	" " 10.
20. Undertakers	Not over 10.
21. Miscellaneous concerns, not elsewhere specified, including typewriter exchange, type-setting, advertising services, commercial agencies, and detective agencies	" " 10.

REVENUE ACT OF 1918[1]

AN ACT TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

ACT OF FEB. 24, 1919, PUBLIC NO. 254

TITLE I—GENERAL DEFINITIONS

Section 1. That when used in this Act—

The term "person" includes partnerships and corporations, as well as individuals;

The term "corporation" includes associations, joint-stock companies, and insurance companies;

The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

The term "Secretary" means the Secretary of the Treasury;

The term "Commissioner" means the Commissioner of Internal Revenue;

The term "collector" means collector of internal revenue;

The term "Revenue Act of 1916" means the Act entitled "An Act to increase the revenue, and for other purposes," approved September 8, 1916;

The term "Revenue Act of 1917" means the Act entitled "An Act to provide revenue to defray war expenses, and for other purposes," approved October 3, 1917;

The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law;

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1 Only those parts of the Act which apply to the taxes treated in this book are reprinted here.

The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such term;

The term "present war" means the war in which the United States is now engaged against the German Government.

For the purposes of this Act the date of the termination of the present war shall be fixed by proclamation of the President.

TITLE II—INCOME TAX

PART I—GENERAL PROVISIONS

DEFINITIONS

Sec. 200. That when used in this title—

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918;

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive;

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

DIVIDENDS

Sec. 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution

made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after passage of this Act, then such dividend shall, in the manner provided in section 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.

(e) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.

BASIS FOR DETERMINING GAIN OR LOSS

Sec. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

INVENTORIES

Sec. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

NET LOSSES

Sec. 204. (a) That as used in this section the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations amounts allowed as a deduction under paragraph (6) of subdivision (a) of section 234) over the sum of the gross income plus any interest received free from taxation both under this title and under Title III.

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the Commissioner with the approval of the Secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such

redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the Commissioner with the approval of the Secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the Commissioner with the approval of the Secretary.

FISCAL YEAR WITH DIFFERENT RATES

Sec. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period: *Provided*, That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (1).

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, and by Title I of the Revenue Act of 1917, shall be credited towards the payment of the tax imposed for such fiscal year by this act, and if the amount so paid exceeds the amount of such tax imposed by this act, or, in the case of a personal service corporation, the amount specified in clause (1), the excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes a return for a fiscal year beginning in 1918 and ending in 1919, the tax under this title for such fiscal year shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year of 1918 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1919 which portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a fiscal year of a partnership begins in 1917 and ends in 1918 or begins in 1918 and ends in 1919, then notwithstanding the provisions of subdivision (b) of section 218, (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law

applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year: *Provided,* That in the case of a personal service corporation with respect to a fiscal year beginning in 1917 and ending in 1918, the amount specified in clause (1) shall not be subject to normal tax.

PARTS OF INCOME SUBJECT TO RATES FOR DIFFERENT YEARS

Sec. 206. That whenever parts of a taxpayer's income are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year: but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed.

PART II—INDIVIDUALS

NORMAL TAX

Sec. 210. That, in lieu of the taxes imposed by subdivision (a) of section 1 of the Revenue Act of 1916 and by section 1 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax at the following rates:

(a) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 6 per centum;

(b) For each calendar year thereafter, 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX

Sec. 211. (a) That, in lieu of the taxes imposed by subdivision (b) of section 1 of the Revenue Act of 1916 and by section 2 of the Revenue Act of 1917, but in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36 000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46 000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000.

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150 000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, (or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

NET INCOME DEFINED

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the compuation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

GROSS INCOME DEFINED

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such prop-

erty; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation; *Provided*, That every person owning any of the obligations, securities or bonds enumerated in clauses (a), (b), (c) and (d) shall, in return required by this title, submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts autherizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under this title and under Title III;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political

subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) So much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces, as does not exceed $3,500.

(c) In the case of nonresident alien individuals, gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a non-resident alien individual, the proportion of such interest which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase

the value of the property assessed; or (d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (e) in the case of a non-resident alien individual, by the authority of any foreign country (except income, war-profits and excess-profits taxes and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit though not connected with the trade or business; but in the case of a non-resident alien individual only as to such transactions within the United States;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a non-resident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise;

(7) Debts ascertained to be worthless and charged off within the taxable year;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair

market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary. In the case of a non-resident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to such vocational rehabilitation fund;

(12) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(b) In the case of a non-resident alien individual the deductions allowed in paragraphs (1), (4), (7), (8), (9), (10) and (12), and clause (e) of paragraph (3), of subdivision (a) shall be allowed only if and to the extent that they are connected with income arising from a source within the United States;

and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ITEMS NOT DEDUCTIBLE

Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(d) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

CREDITS ALLOWED

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together shall receive but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them;

(d) $200 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a non-resident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.

NON-RESIDENT ALIENS—ALLOWANCE OF DEDUCTIONS AND CREDITS

Sec. 217. That a non-resident alien individual shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be

filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed by this title, including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided*, That the benefit of the credits allowed in subdivisions (c) and (d) of section 216 may, in the discretion of the Commissioner, and except as otherwise provided in subdivision (e) of that section, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such non-resident alien individual shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

SEC. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(b) If a fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year shall apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to the remainder.

(c) In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, shall, for the purpose of determining the tax imposed by this title, be credited against that portion of the net income embraced in his personal return for the taxable year 1918 to which the rates for 1917 apply.

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(e) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to

personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

ESTATES AND TRUSTS

Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that there shall also be allowed as a deduction (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; and in cases under paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of each beneficiary's distributive share of such net income, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraph (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary.

but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the estate or trust is computed, then his distributive share of the net income of the estate or trust for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF TAX AT SOURCE

Sec. 221. (a) That all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any non-resident alien individual (other than income received as dividends from a corporation which is taxable under this title upon its net

income) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided*. That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a non-resident alien individually or to an individual citizen or resident of the United States or to a partnership: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1, a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a non-resident alien individual if so provided for in regulations prescribed by the Commissioner under section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March first of each year and shall on or before June fifteenth pay the tax to the official of the United States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES

Sec. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States, the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of any such taxes paid during the taxable year to such country, upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, and all other information necessary for the computation of such credits.

INDIVIDUAL RETURNS

Sec. 223. That every individual having a net income for the taxable year of $1,000 or over if single or if married and not living with husband or wife, or of $2,000 or over if married and living with husband or wife, shall make under oath a return stating specifically the items of his gross income and the deductions and credits allowed by this title. If a husband and wife living together have an aggregate net income of $2,000 or over, each shall make such a return unless the income of each is included in a single joint return.

If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS

Sec. 224. That every partnership shall make a return for each taxable year stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS

Sec. 225. That every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a non-resident alien, stating specifically the items of the gross income and the deductions and credits allowed by this title. Under such regulations as the Commissioner with the aproval of the Secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be a sufficient compliance with the above requirement. The fiduciary shall make oath that he has sufficient knowledge of the affairs of such individual, estate or trust to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.

Fiduciaries required to make returns under this Act shall be subject to all the provisions of this Act which apply to individuals.

RETURNS WHEN ACCOUNTING PERIOD CHANGED

Sec. 226. That if a taxpayer, with the aproval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December thirty-first. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year.

In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of section 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

TIME AND PLACE FOR FILING RETURNS

Sec. 227. (a) That returns shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the fifteenth day of March. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

PART III—CORPORATIONS

TAX ON CORPORATIONS

Sec. 230. (a) That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and

(2) For each calendar year thereafter, 10 per centum of such excess amount.

(b) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems while under Federal

control, for the just compensation of their owners, and for other purposes," five-sixths of the tax imposed by paragraph (1) of subdivision (a) and four-fifths of the tax imposed by paragraph (2) of subdivision (a) shall be treated as levied by an Act in amendment of Title I of the Revenue Act of 1917.

CONDITIONAL AND OTHER EXEMPTIONS

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members;

(6) Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the act approved July 17, 1916, entitled "An Act to provide

capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes;"

(14) Personal service corporations.

NET INCOME DEFINED

Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. {part year}

GROSS INCOME DEFINED

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, except that:

(1) In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.

(2) Mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation gross income includes only the gross income from sources within the United States, including the interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation

under this title as income to the taxpayer, or, in the case of a foreign corporation, the proportion of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a domestic corporation, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or (e) in the case of a foreign corporation, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon the property or business: *Provided*, That in the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

(5) Debts ascertained to be worthless and charged off within the taxable year;

(6) Amounts received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be

credited or refunded to the taxpayer in accordance with the provisions of section 252;

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(10) In the case of insurance companies, in addition to the above: (a) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (b) the sums other than dividends paid within the taxable year on policy and annuity contracts;

(11) In the case of corporations issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, (unless otherwise allowed under such paragraphs) the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts

CORPORATION RETURNS

Sec. 239. That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (c) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

CONSOLIDATED RETURNS

Sec. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income and invested capital for the purposes of this title and Title III, and the taxes thereunder shall be computed and determined upon the basis of such return: *Provided*, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of \$2,000 (as provided in section 236); in computing the war-profits credit (as provided in section 311) only one specific exemption of \$3,000; and in computing the ex-

cess-profits credit (as provided in section 312) only one specific exemption of $3,000.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

(c) For the purposes of section 238 a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war-profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid: *Provided,* That in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under section 234) received by such domestic corporation during the taxable year.

TIME AND PLACE FOR FILING RETURNS

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

PART IV—ADMINISTRATIVE PROVISIONS

PAYMENT OF TAXES

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted

until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference shall, to the extent not covered by any credits then due to the taxpayer under section 252, be paid upon notice and demand by the collector. In such case if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due.

If the understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the amount of the deficiency.

(c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) Except in the case of false or fraudulent returns with intent to evade the tax, the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or was made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time

it became due: *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of ½ of 1 per centum per month.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.

(f) In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, there shall also be added as part of the tax the sum of $5.

(g) If the Commisioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.

RECEIPTS FOR TAXES

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making

such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS

Sec. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, or the Revenue Act of 1917, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided* That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.

PENALTIES

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

RETURNS OF PAYMENTS OF DIVIDENDS

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

RETURNS OF BROKERS

Sec. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commisisoner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

INFORMATION AT SOURCE

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1918 and

each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

Sec. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

Sec. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits-tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall

be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF UNITED STATES POSSESSIONS

Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

PORTO RICO AND PHILIPPINE ISLANDS

Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid in accordance with the provisions of the Revenue Act of 1916 as amended.

Returns shall be made and taxes shall be paid under Title I of such Act in Porto Rico or the Philippine Islands, as the case may be, by (1) every individual who is a citizen or resident of Porto Rico or the Philippine Islands or derives income from sources therein, and (2) every corporation created or organized in Porto Rico or the Philippine Islands or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippine Islands but derives income from sources therein, shall be taxed in Porto Rico or the Philippine Islands as a non-resident alien individual, and a corporation created or organized outside Porto Rico or the Philippine Islands and deriving income from sources therein shall be taxed in Porto Rico or the Philippine Islands as a foreign corporation. For the purposes of section 216 and of paragraph (6) of subdivision (a) of section 234 a tax imposed in Porto Rico or the Philippine Islands upon the net income of a corporation shall not be deemed to be a tax under this title.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

TITLE III—WAR-PROFITS AND EXCESS-PROFITS TAX

PART I—GENERAL DEFINITIONS

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201. The first taxable year for the purposes of this title shall be the same as the first taxable year for the purposes of the income tax under Title II.

Part II—Imposition of Tax

Sec. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

First Bracket

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

Third Bracket

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The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following;

First Bracket

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such a year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(d) In any case where the full amount of the excess-profit credit is not allowed under the first bracket of subdivision (a) or (b), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

(e) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems while under Federal control, for the just compensation of their owners, and for other purposes," the tax imposed by this title shall be treated as levied by an Act in amendment of Title II of the Revenue Act of 1917.

Sec. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 30 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 80 per centum of the amount of the net income in excess of $20,000; the tax imposed by subdivision (b) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the above limitations shall apply to the taxes computed under subdivisions (a) and (b) of section 301, respectively, when used in subdivision (c) of that section. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301.

Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in sections 311 and 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided,* That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are de-

termined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

Sec. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income shall be the proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Sec. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

Part III—Credits

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Sec. 310. That as used in this title the term "prewar period" means the calendar years 1911, 1912, and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence.

Sec. 311. (a) That the war-profits credit shall consist of the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the average net income of the corporation for the prewar period, plus or minus, as the case may be, 10 per centum of the difference between the average invested capital for the prewar period and the invested capital for the taxable year. If the tax is computed for a period of less than twelve months such amount shall be reduced to the same proportion thereof as the number of months in the period is of twelve months.

(b) If the corporation had no net income for the prewar period, or if the amount computed under paragraph (2) of subdivision (a) is less than 10 per centum of its invested capital for the taxable year, then the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to 10 per centum of the invested capital for the taxable year.

(c) If the corporation was not in existence during the whole of at least one calendar year during the prewar period, then, except as provided in subdivision (d), the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capi-

tal of the taxpayer for the taxable year. Such average percentage shall be determined by the Commissioner on the basis of data contained in returns made under Title II of the Revenue Act of 1917, and the average known as the median shall be used. If such average percentage has not been determined and published at least 30 days prior to the time when the return of the taxpayer is due, then for purposes of such return 10 per centum shall be used in lieu thereof; but such average percentage when determined shall be used for the purposes of section 250 in determining the correct amount of the tax.

(d) The war-profits credit shall be determined in the manner provided in subdivision (b) instead of in the manner provided in subdivision (c), in the case of any corporation which was not in existence during the whole of at least one calendar year during the prewar period, if (1) a majority of its stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period, or if (2) 50 per centum or more of its gross income (as computed under section 233 for income tax purposes) consists of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

(e) A foreign corporation shall not be entitled to a specific exemption of $3,000.

Sec. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation shall not be entitled to the specific exemption of $3,000.

Part IV—Net Income

Sec. 320. (a) That for the purpose of this title the net income of a corporation shall be ascertained and returned—

(1) For the calendar years 1911 and 1912 upon the same basis and in the same manner as provided in section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, except that taxes imposed by such section and paid by the corporation within the year shall be included;

(2) For the calendar year 1913 upon the same basis and in the same manner as provided in Section II of the Act entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," approved October 3, 1913, except that taxes imposed by section 38 of such Act of August 5, 1909, and paid by the corporation within the year shall be included, and except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by Section II of such Act of October 3, 1913, shall be deducted; and

(3) For the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

(b) The average net income for the prewar period shall be determined by

dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.

Part V—Invested Capital

Sec. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulæ, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326, section 330, and section 331.

(b) For the purposes of this title, the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

Sec. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued

therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311 be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

Sec. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section

would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 per centum per month on such excess from the time the installment was due.

(c) The Commisisoner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner

shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

PART VI—REORGANIZATIONS

SEC. 330. That in the case of the reorganization, consolidation, or change of ownership after January 1, 1911, of a trade or business now carried on by a corporation, the corporation shall for the purposes of this title be deemed to have been in existence prior to that date, and the net income and invested capital of such predecessor trade or business for all or any part of the prewar period prior to the organization of the corporation now carrying on such trade or business shall be deemed to have been the net income and invested capital of such corporation.

If such predecessor trade or business was carried on by a partnership or individual the net income for the prewar period shall, under regulations prescribed by the Commissioner with the approval of the Secretary, be ascertained and returned as nearly as may be upon the same basis and in the same manner as provided for corporations in Title II, including a reasonable deduction for salary or compensation to each partner or the individual for personal services actually rendered.

In the case of the organization as a corporation before July 1, 1919, of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1918, and the undistributed profits or earnings of such trade or business shall not be subject to the surtax imposed in section 211, but amounts distributed on or after January 1, 1918, from the earnings of such trade or business shall be taxed to the recipients as dividends, and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this paragraph shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20 per centum of its invested capital for such year: *Provided further*, That any tax payer who takes advantage of this paragraph shall pay the tax imposed by section 1000 of this Act and by the first subdivision of section 407 of the Revenue Act of 1916, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value.

If any asset of the trade or business in existence both during the taxable year and any prewar year is included in the invested capital for the taxable year but is not included in the invested capital for such prewar year, or is valued on a different basis in computing the invested capital for the taxable year and such prewar year, respectively, then under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary such readjustments shall be made as are necessary to place the computation of the

invested capital for such prewar year on the basis employed in determining the invested capital for the taxable year.

Sec. 331. In the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided*, That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

Part VII—Miscellaneous

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1917 and ending in 1918, the tax for the first taxable year under this title shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified in subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1917 shall be credited toward the payment of the tax imposed for such fiscal year by this title, and if the amount so paid exceeds the amount of the tax imposed by this title, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252.

(b) If a corporation makes return for a fiscal year beginning in 1918 and ending in 1919, the tax for such fiscal year under this title shall be the sum of: (1) the same proportion of a tax for the entire period computed under subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under subdivision (b) or (c) of section 301 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a partnership or a personal service corporation makes return for a fiscal year beginning in 1917 and ending in 1918, it shall pay the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period.

Any tax paid by a partnership or personal service corporation for any

period beginning on or after January 1, 1918, shall be immediately refunded to the partnership or corporation as a tax erroneously or illegally collected.

Sec. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

TITLE X—SPECIAL TAXES

[Capital Stock Tax]

Sec. 1000. (a) That on and after July 1, 1918, in lieu of the tax imposed by the first subdivision of section 407 of the Revenue Act of 1916—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June thirtieth.

(b) In computing the tax in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

(c) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or in the case of a foreign corporation not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231. The taxes imposed by this section shall apply to mutual insurance companies, and in the case of every such domestic company the tax shall be equivalent to $1 for each $1,000 of the excess over $5,000 of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of Title II, as of the close of the preceding accounting period used by such company for purposes of making its income tax return: *Provided*, That in the case of a foreign mutual insurance company the tax shall be equivalent to $1 for each $1,000 of the same proportion of the sum of such surplus and reserves, which the reserve fund upon business transacted within the United

States is of the total reserve upon all business transacted, as of the close of the preceding accounting period used by such company for purposes of making its income tax return.

(d) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

* * * *

TITLE XI—STAMP TAXES

Sec. 1100. That on and after April 1, 1919, there shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in Schedule A of this title, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, by any person who makes, signs, issues, sells, removes, consigns, or ships the same, or for whose use or benefit the same are made, signed, issued, sold, removed, consigned, or shipped, the several taxes specified in such schedule. The taxes imposed by this section shall, in the case of any article upon which a corresponding stamp tax is now imposed by law, be in lieu of such tax.

Sec. 1101. That there shall not be taxed under this title any bond, note, or other instrument, issued by the United States, or by any foreign Government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; or any bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States; or stocks and bonds issued by cooperative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigating companies.

Sec. 1102. That whoever—

(a) Makes, signs, issues, or accepts, or causes to be made, signed, issued, or accepted, any instrument, document, or paper of any kind or description whatsoever without the full amount of tax thereon being duly paid;

(b) Consigns or ships, or causes to be consigned or shipped, by parcel post any parcel, package, or article without the full amount of tax being duly paid;

(c) Manufactures or imports and sells, or offers for sale, or causes to be manufactured or imported and sold, or offered for sale, any playing cards, package, or other article without the full amount of tax being duly paid;

(d) Makes use of any adhesive stamp to denote any tax imposed by this title without canceling or obliterating such stamp as prescribed in section *1104*;

Is guilty of a misdemeanor and upon conviction thereof shall pay a fine of not more than $100 for each offense.

Sec. 1103. That whoever—

(a) Fraudulently cuts, tears, or removes from any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, any adhesive stamp or the impression of any stamp, die, plate, or other article provided, made, or used in pursuance of this title;

(b) Fraudulently uses, joins, fixes, or places to, with, or upon any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, (1) any adhesive stamp, or the impression of any stamp, die, plate, or other article, which has been cut, torn, or removed from any other vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title; or (2) any adhesive stamp or the impression of any stamp, die, plate, or other article of insufficient value; or (3) any forged or counterfeit stamp, or the impression of any forged or counterfeit stamp, die, plate, or other article;

(c) Willfully removes, or alters the cancellation, or defacing marks of, or otherwise prepares, any adhesive stamp, with intent to use, or cause the same to be used, after it has been already used, or knowingly or willfully buys, sells, offers for sale, or gives away, any such washed or restored stamp to any person for use, or knowingly uses the same;

(d) Knowingly and without lawful excuse (the burden of proof of such excuse being on the accused) has in possession any washed, restored, or altered stamp, which has been removed from any vellum, parchment, paper, instrument, writing, package, or article;

Is guilty of a misdemeanor, and upon conviction shall be punished by a fine of not more than $1,000, or by imprisonment for not more than five years, or both, and any such reused, canceled, or counterfeit stamp and the vellum, parchment, document, paper, package, or article upon which it is placed or impressed shall be forfeited to the United States.

Sec. 1104. That whenever an adhesive stamp is used for denoting any tax imposed by this title, except as hereinafter provided, the person using or affixing the same shall write or stamp or cause to be written or stamped thereupon the initials of his or its name and the date upon which the same is attached or used, so that the same may not again be used: *Provided*, That the Commissioner may prescribe such other method for the cancellation of such stamps as he may deem expedient.

Sec. 1105. (a) That the Commissioner shall cause to be prepared and distributed for the payment of the taxes prescribed in this title suitable stamps denoting the tax on the document, articles, or thing to which the same may be affixed, and shall prescribe such method for the affixing of said stamps in substitution for or in addition to the method provided in this title, as he may deem expedient.

(b) The Commissioner, with the approval of the Secretary, is authorized to procure any of the stamps provided for in this title by contract whenever such stamps can not be speedily prepared by the Bureau of Engraving and Printing; but this authority shall expire on January 1, 1920, except as to imprinted stamps furnished under contract, authorized by the Commissioner.

(c) All internal-revenue laws relating to the assessment and collection of taxes are hereby extended to and made a part of this title, so far as applicable, for the purpose of collecting stamp taxes omitted through mistake or fraud from any instrument, document, paper, writing, parcel, package, or article named herein.

Sec. 1106. That the Commissioner shall furnish to the Postmaster General without prepayment a suitable quantity of adhesive stamps to be distributed

to and kept on sale by the various postmasters in the United States. The Postmaster General may require each such postmaster to give additional or increased bond as postmaster for the value of the stamps so furnished, and each such postmaster shall deposit the receipts from the sale of such stamps to the credit of and render accounts to the Postmaster General at such times and in such form as he may by regulations prescribe. The Postmaster General shall at least once monthly transfer all collections from this source to the Treasury as internal-revenue collections.

Sec. 1107. That the collectors of the several districts shall furnish without prepayment to any assistant treasurer or designated depositary of the United States located in their respective collection districts a suitable quantity of adhesive stamps for sale. In such cases the collector may require a bond, with sufficient sureties, to an amount equal to the value of the adhesive stamps so furnished, conditioned for the faithful return, whenever so required, of all quantities or amounts undisposed of, and for the payment monthly of all quantities or amounts sold or not remaining on hand. The Secretary may from time to time make such regulations as he may find necessary to insure the safekeeping or prevent the illegal use of all such adhesive stamps.

Schedule A—Stamp Taxes

1. Bonds of indebtedness: On all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue: *Provided further*, That when a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax shall be based upon the amount secured.

2. Bonds, indemnity and surety: On all bonds executed for indemnifying any person who shall have become bound or engaged as surety, and on all bonds executed for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, and on all policies of guaranty and fidelity insurance, including policies guaranteeing titles to real estate and mortgage guarantee policies, and on all other bonds of any description, made, issued, or executed, not otherwise provided for in this schedule, except such as may be required in legal proceedings, 50 cents: *Provided*, That where a premium is charged for the issuance, execution, renewal or continuance of such bond the tax shall be 1 cent on each dollar or fractional part thereof the premium charged: *Provided further*, That policies of reinsurance shall be exempt from the tax imposed by this subdivision.

3. Capital stock, issued: On each original issue, whether on organization or reorganization, of certificates of stock, or of profits, or of interest in property or accumulations, by any corporation, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That where a certificate is issued without face value, the tax shall be 5 cents per share, unless the actual value is in ex-

cess of $100 per share, in which case the tax shall be 5 cents on each $100 of actual value or fraction thereof.

The stamps representing the tax imposed by this subdivision shall be attached to the stock books and not to the certificates issued.

4. Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest, or rights, or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares are without par or face value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of $100 per share, in which case the tax shall be 2 cents on each $100 of actual value or fraction thereof: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is shown only by the books of the corporation the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the seller, the amount of the sale and the matter or thing to which it refers. Any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale, or who in pursuance of any such sale delivers any certificate or evidence of the sale of any stock, interest or right, or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both.

5. Produce, sales of, on exchange: Upon each sale, agreement of sale, or agreement to sell (not including so-called transferred or scratch sales), any products or merchandise at, or under the rules or usages of, any exchange, or board of trade, or other similar place, for future delivery, for each $100 in value of the merchandise covered by said sale or agreement of sale or agreement to sell, 2 cents, and for each additional $100 or fractional part thereof in excess of $100, 2 cents: *Provided*, That on every sale or agreement

of sale or agreement to sell as aforesaid there shall be made and delivered by the seller to the buyer a bill, memorandum, agreement, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp or stamps in value equal to the amount of the tax on such sale: *Provided further*, That sellers of commodities described herein, having paid the tax provided by this subdivision, may transfer such contracts to a clearing-house corporation or association, and such transfer shall not be deemed to be a sale, or agreement of sale, or an agreement to sell within the provisions of this Act, provided that such transfer shall not vest any beneficial interest in such clearing-house association but shall be made for the sole purpose of enabling such clearing-house association to adjust and balance the accounts of the members of such clearing-house association on their several contracts. Every such bill, memorandum, or other evidence of sale or agreement to sell shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers; and any person liable to pay the tax as herein provided or anyone who acts in the matter as agent or broker for such person, who makes any such sale or agreement of sale, or agreement to sell, or who, in pursuance of any such sale, agreement of sale, or agreement to sell, delivers any such products or merchandise without a bill, memorandum, or other evidence thereof as herein required, or who delivers such bill, memorandum, or other evidence of sale, or agreement to sell, without having the proper stamps affixed thereto, with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000 or be imprisoned not more than six months, or both.

No bill, memorandum, agreement, or other evidence of such sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered shall be subject to this tax.

6. Drafts or checks (payable otherwise than at sight or on demand) upon their acceptance or delivery within the United States whichever is prior, promissory notes, except bank notes issued for circulation, and for each renewal of the same, for a sum not exceeding $100, 2 cents; and for each additional $100, or fractional part thereof, 2 cents.

This subdivision shall not apply to a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations: *Provided*, That in either case the par value of such bonds or obligations shall be not less than the amount of such note.

7. Conveyances: Deed, instrument, or writing, whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his, her, or their direction, when the consideration or value of the interest or property conveyed, exclusive of the value of any lien or encumbrance remaining thereon at the time of sale, exceels $100 and does not exceed $500, 50 cents; and for each aditional $500 or fractional part thereof,

50 cents. This subdivision shall not apply to any instrument or writing given to secure a debt.

8. Entry of any goods, wares, or merchandise at any customhouse, either for consumption or warehousing, not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, $1.

9. Entry for the withdrawal of any goods or merchandise from customs bonded warehouse, 50 cents.

10. Passage ticket, one way or round trip, for each passenger, sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada, or Mexico, if costing not exceeding $30, $1; costing more than $30 and not exceeding $60, $3; costing more than $60, $5. This subdivision shall not apply to passage tickets costing $10 or less.

11. Proxy for voting at any election for officers, or meeting for the transaction of business, of any corporation, except religious, educational, charitable, fraternal, or literary societies, or public cemeteries, 10 cents.

12. Power of attorney granting authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee, 25 cents. This subdivision shall not apply to any papers necessary to be used for the collection of claims from the United States or from any State for pensions, back pay, bounty, or for property lost in the military or naval service, or to powers of attorney required in bankruptcy cases.

13. Playing cards: Upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold, or removed for consumption or sale, a tax of 8 cents per pack.

14. Parcel-post packages: Upon every parcel or package transported from one point in the United States to another by parcel post on which the postage amounts to 25 cents or more, a tax of 1 cent for each 25 cents or fractional part thereof charged for such transportation, to be paid by the consignor.

No such parcel or package shall be transported until a stamp or stamps representing the tax due shall have been affixed thereto.

15. On each policy of insurance, or certificate, binder, covering note, memorandum, cablegram, letter, or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including transshipments and storage at termini or way points) or by fire, lightning, tornado, wind-storm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a State, Territory, or district of the United States within which such insurer is authorized to do business, a tax of 3 cents on each dollar, or fractional part thereof of the premium charged: *Provided,* That policies of re-insurance shall be exempt from the tax imposed by this subdivision.

Any person to or for whom or in whose name any such policy or other instrument is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such policy or other instrument, shall

affix the proper stamps to such policy or other instrument, and for failure to affix such stamps with intent to evade the tax shall, in addition to other penalties provided therefor, pay a fine of double the amount of the tax.

TITLE XII—TAX ON EMPLOYMENT OF CHILD LABOR

Sec. 1200. That every person (other than a bona fide boys' or girls' canning club recognized by the Agricultural Department of a State and of the United States) operating (a) any mine or quarry situated in the United States in which children under the age of sixteen years have been employed or permitted to work during any portion of the taxable year; or (b) any mill, cannery, workshop, factory, or manufacturing establishment situated in the United States in which children under the age of fourteen years have been employed or permitted to work, or children between the ages of fourteen and sixteen have been employed or permitted to work more than eight hours in any day or more than six days in any week, or after the hour of seven o'clock post meridian, or before the hour of six o'clock ante meridian, during any portion of the taxable year, shall pay for each taxable year, in addition to all other taxes imposed by law, an excise tax equivalent to 10 per centum of the entire net profits received or accrued for such year from the sale or disposition of the product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment.

Sec. 1201. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such products manufactured within the United States the following items:

(a) The cost of raw materials entering into the production;

(b) Running expenses, including rentals, cost of repairs, and maintenance, heat, power, insurance, management, and a reasonable allowance for salaries or other compensations for personal services actually rendered, and for depreciation;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the production; and

(e) Losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm, or other casualties, and not compensated for by insurance or otherwise.

Sec. 1202. That if any such person during any taxable year or part thereof, whether under any agreement, arrangement, or understanding or otherwise, sells or disposes of any product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment at less than the fair market price obtainable therefor either (a) in such manner as directly or indirectly to benefit such person or any person directly or indirectly interested in the business of such person; or (b) with intent to cause such benefit; the gross

amount received or accrued for such year or part thereof from the sale or disposition of such product shall be taken to be the amount which would have been received or accrued from the sale or disposition of such product if sold at the fair market price.

Sec. 1203. (a) That no person subject to the provisions of this title shall be liable for the tax herein imposed if the only employment or permission to work which but for this section would subject him to the tax, has been of a child as to whom such person has in good faith procured at the time of employing such child or permitting him to work, and has since in good faith relied upon and kept on file a certificate, issued in such form, under such conditions and by such persons as may be prescribed by a board consisting of the Secretary, the Commissioner, and the Secretary of Labor, showing the child to be of such age as not to subject such person to the tax imposed by this title. Any person who knowingly makes a false statement or presents false evidence in or in relation to any such certificate or application therefor shall be punished by a fine of not less than $100, nor more than $1,000, or by imprisonment for not more than three months, or by both such fine and imprisonment, in the discretion of the court.

In any State designated by such board an employment certificate or other similar paper as to the age of the child, issued under the laws of that State, and not inconsistent with the provisions of this title, shall have the same force and effect as a certificate herein provided for.

(b) The tax imposed by this title shall not be imposed in the case of any person who proves to the satisfaction of the Secretary that the only employment or permission to work which but for this section would subject him to the tax, has been of a child employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax.

Sec. 1204. That on or before the first day of the third month following the close of each taxable year, a true and accurate return under oath shall be made by each person subject to the provisions of this title to the collector for the district in which such person has his principal office or place of business, in such form as the Commissioner, with the approval of the Secretary, shall prescribe, setting forth specifically the gross amount of income received or accrued during such year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment, in which children have been employed subjecting him to the tax imposed by this title, and from the total thereof deducting the aggregate items of allowance authorized by this title, and such other particulars as to the gross receipts and items of allowance as the Commissioner, with the approval of the Secretary may require.

Sec. 1205. That all such returns shall be transmitted forthwith by the collector to the Commissioner, who shall, as soon as practicable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before thirty days from the date of such notice.

Sec. 1206. That for the purposes of this Act the Commissioner, or any other person duly authorized by him, shall have authority to enter and in-

spect at any time any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, shall, for the purpose of complying with a request of the Commissioner to make such an inspection, have like authority, and shall make report to the Commissioner of inspections made under such authority in such form as may be prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Any person who refuses or obstructs entry or inspection authorized by this section shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both such fine and imprisonment.

Sec. 1207. That as used in this title the term "taxable year" shall have the same meaning as provided for the purposes of income tax in section 200. The first taxable year for the purposes of this title shall be the period between sixty days after the passage of this Act and December 31, 1919, both inclusive, or such portion of such period as is included within the fiscal year (as defined in section 200) of the taxpayer.

TITLE XIII—GENERAL ADMINISTRATIVE PROVISIONS[1]

Section 1301. (d) (1) There is hereby created a board to be known as the "Advisory Tax Board," hereinafter called the Board, and to be composed of not to exceed six members to be appointed by the Commissioner with the approval of the Secretary. The Board shall cease to exist at the expiration of two years after the passage of this Act, or at such earlier time as the Commissioner with the approval of the Secretary may designate.

Vacancies in the membership of the Board shall be filled in the same manner as an original appointment. Any member shall be subject to removal by the Commissioner with the approval of the Secretary. The Commissioner with the approval of the Secretary shall designate the chairman of the Board. Each member shall receive an annual salary of $9,000, payable monthly, together with actual necessary expenses when absent from the District of Columbia on official business.

(2) The Commissioner may, and on the request of any taxpayer directly interested shall, submit to the Board any question relating to the interpretation or administration of the income, war-profits or excess-profits tax laws, and the Board shall report its findings and recommendations to the Commissioner.

(3) The Board shall have its office in the Bureau of Internal Revenue in the District of Columbia. The expenses and salaries of members of the Board shall be audited, allowed, and paid out of appropriations for collecting internal revenue, in the same manner as expenses and salaries of employees of the Bureau of Internal Revenue are audited, allowed, and paid.

(4) The Board shall have the power to summon witnesses, take testimony, administer oaths, and to require any person to produce books, papers, documents, or other data relating to any matter under investigation by the Board. Any member of the Board may sign subpoenas and members and

[1] Parts of this title are omitted, being general provisions of no direct application to the taxes treated in this book.

employees of the Bureau of Internal Revenue designated to assist the Board, when authorized by the Board, may administer oaths, examine witnesses, take testimony and receive evidence.

Sec. 1305. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Sec. 1307. That in all cases where the method of collecting the tax imposed by this Act is not specifically provided in this Act, the tax shall be collected in such manner as the Commissioner, with the approval of the Secretary, may prescribe. All administrative and penalty provisions of Title XI of this Act, in so far as applicable, shall apply to the collection of any tax which the Commissioner determines or prescribes shall be paid by stamp.

Sec. 1308. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a return or supply any information for the purposes of the computation, assessment or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by

law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however,* That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or of section 605 or 620 of this Act, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Sec. 1309. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

Sec. 1313. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Sec. 1314. That collectors may receive, at par with an adjustment for accrued interest, certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

Sec. 1316. (a) That section 3220 of the Revised Statutes is hereby amended to read as follows:

"Sec. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

(b) Section 3225 of the Revised Statutes of the United States is hereby amended to read as follows:

"Sec. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

(c) That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal-revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Sec. 1317. That sections 3164, 3165, 3167, 3172, 3173, and 3176 of the Revised Statutes as amended are hereby amended to read as follows:

"Sec. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"Sec. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operation, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be

punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"Sec. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"Sec. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided*, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, article or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collcetor to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further*, That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector

to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided*, That 'person,' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Sec. 1318. That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have juris-

diction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

Sec. 1319. That whoever in connection with the sale or lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

Sec. 1320. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds deposited hereunder, and such other United States bonds as may be substituted therefor from time to time as such security, may be deposited with the Treasurer, or an Assistant Treasurer of the United States, a Government depository, Federal Reserve bank, or member bank, which shall issue receipt therefor, describing such bonds so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds so deposited, shall be returned to the depositor: *Provided*, That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat., 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An Act for the protection of persons furnishing materials and labor for the construction of public works,'" shall file with the obligee, at any time after a default in the performance of any contract subject

to said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or proceeds subject to the order of the court having jurisdiction thereof: *Provided further,* That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bond: *Provided further,* That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further,* That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

TITLE XIV—GENERAL PROVISIONS

Sec. 1400. (a) That the following parts of Acts are hereby repealed, subject to the limitations provided in subdivision (b):

(1) The following titles of the Revenue Act 1916:

Title I (called "Income Tax");

Title II (called "Estate Tax");

Title III (called "Munitions Manufacturers' Tax"), as amended;

Title IV (called "Miscellaneous Taxes").

(2) The following parts of the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917:

Title III (called "Estate Tax");

Section 402 (called "Returns of Dividends").

(3) The following titles of the Revenue Act of 1917:

Title I (called "War Income Tax");

Title II (called "War Excess-Profits Tax");

Title III (called "War Tax on Beverages");

Title IV (called "War Tax on Cigars, Tobacco, and Manufactures Thereof");

Title V (called "War Tax on Facilities Furnished by Public Utilities, and Insurance");

Title VI (called "War Excise Taxes");

Title VII (called "War Tax on Admissions and Dues");

Title VIII (called "War Stamp Taxes");

Title IX (called "War Estate Tax");

Title X (called "Administrative Provisions");

Title XII (called "Income Tax Amendments").

(b) Such parts of Acts shall remain in force for the assessment and collection of all taxes which have accrued thereunder and for the imposition

and collection of all penalties or forfeitures which have accrued and may accrue in relation to any such taxes, and except that the unexpended balance of any appropriation heretofore made and now available for the administration of any such part of an Act shall be available for the administration of this Act or the corresponding provision thereof: *Provided*, That except as otherwise provided in this Act, no taxes shall be collected under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, or Title I or II of the Revenue Act of 1917, in respect to any period after December 31, 1917: *Provided further*, That the assessment and collection of all estate taxes, and the imposition and collection of all penalties or forfeitures, which have accrued under Title II of the Revenue Act of 1916 as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917, or Title IX of the Revenue Act of 1917, shall be according to the provisions of Title IV of this Act. In the case of any tax imposed by any part of an Act herein repealed, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act.

Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 shall remain in force for the assessment and collection of the income tax in Porto Rico and the Philippine Islands, except as may be otherwise provided by their respective legislatures.

Sec. 1401. That section 1100 of the Revenue Act of 1917 is hereby repealed, to take effect on July 1, 1919, and thereafter the rate of postage on all mail matter of the first class shall be the same as the rate in force on October 2, 1917: *Provided*, That letters written and mailed by soldiers, sailors, and marines assigned to duty in a foreign country engaged in the present war may be mailed free of postage, subject to such rules and regulations as may be prescribed by the Postmaster General.

Section 1107 of such Act is hereby repealed, to take effect July 11, 1919.

Sec. 1402. That if any clause, sentence, paragraph, or part of this Act shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this Act, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment has been rendered.

Sec. 1403. That the Revenue Act of 1916 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 903. That this Act may be cited as the 'Revenue Act of 1916.'"

Sec. 1404. That the Revenue Act of 1917 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 1303. That this Act may be cited as the 'Revenue Act of 1917.'"

Sec. 1405. That this Act may be cited as the "Revenue Act of 1918."

Sec. 1408. That every person who on or after April 6, 1917, has entered into any contract, undertaking, or agreement, with the United States, or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having

contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States shall, within thirty days after a request of the Commissioner therefor, file with the Commissioner a true and correct copy of every such contract, undertaking, or agreement.

Whoever fails to comply with such request of the Commissioner shall be guilty of a misdemeanor and shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year or both.

The Commissioner shall (when not violative of the technical military or naval secrets of the Government) have access to all information and data relating to any such contract, undertaking, or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States, and may call upon any such departments, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.

Sec. 1409. That unless otherwise herein specially provided, this Act shall take effect on the day following its passage.

ACT OF JUNE 13, 1898 (30 STAT. 454), AS AMENDED BY ACT OF MARCH 2, 1901 (31 STAT. 940).[1]

Sec. 13. That any person or persons who shall register, issue, sell, or transfer, or who shall cause to be issued, registered, sold, or transferred, any instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, without the same being duly stamped, or having thereupon an adhesive stamp for denoting the tax chargeable thereon, and canceled in the manner required by law, with intent to evade the provisions of this Act, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be punished by a fine not exceeding fifty dollars, or by imprisonment not exceeding six months, or both, in the discretion of the court; and such instrument, document, or paper, not being stamped according to law, shall be deemed invalid and of no effect: *Provided*, That hereafter, in all cases where the party has not affixed to any instrument the stamp required by law thereon at the time of issuing, selling, or transferring the said bonds, debentures, or certificates of stock or of indebtedness, or any instrument, document or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and he or they, or any party having an interest therein, shall be subsequently desirous of affixing such stamp to said instrument, or, if said instrument be lost, to a copy thereof, he or they shall appear before the collector of internal revenue of the proper district, who shall, upon the payment of the price of the proper stamp required by law, and of a penalty of ten dollars, and, where the whole amount of the tax de-

[1] These provisions are referred to in Chapter 45 on the Stamp Tax.

noted by the stamp required shall exceed the sum of fifty dollars, on payment also of interest, at the rate of six per centum, on said tax from the day on which such stamp ought to have been affixed, affix the proper stamp to such bond, debenture, certificate of stock or of indebtedness or copy, or instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and note upon the margin thereof the date of his so doing, and the fact that such penalty has been paid; and the same shall thereupon be deemed and held to be as valid, to all intents and purposes, as if stamped when made or issued: *And provided further*, That where it shall appear to said collector, upon oath or otherwise, to his satisfaction, that any such instrument has not been duly stamped, at the time of making or issuing the same, by reason of accident, mistake, inadvertence, or urgent necessity, and without any wilful design to defraud the United States of the stamp, or to evade or delay the payment thereof, then and in such case, if such instrument, or, if the original be lost, a copy thereof, duly certified by the officer having charge of any records in which such original is required to be recorded or otherwise duly proven to the satisfaction of the collector, shall, within twelve calendar months after the making or issuing thereof, be brought to the said collector of internal revenue to be stamped, and the stamp tax chargeable thereon shall be paid, it shall be lawful for the said collector to remit the penalty aforesaid and to cause such instrument to be duly stamped. And when the original instrument, or a certified, or duly proven copy thereof, as aforesaid, duly stamped so as to entitle the same to be recorded, shall be presented to the clerk, register, recorder, or other officer having charge of the original record it shall be lawful for such officer, upon the payment of the fee legally chargeable for the recording thereof, to make a new record thereof, or to note upon the original record the fact that the error or omission in the stamping of said original instrument has been corrected pursuant to law; and the original instrument or such certified copy, or the record thereof, may be used in all courts and places in the same manner and with like effect as if the instrument had been originally stamped: *And provided further*, That in all cases where the party has not affixed the stamp required by law upon any such instrument issued, registered, sold, or transferred at a time when and at a place where no collection district was established, it shall be lawful for him or them, or any party having an interest therein, to affix the proper stamp thereto, or, if the original be lost, to a copy thereof. But no right acquired in good faith before the stamping of such instrument, or copy thereof, as herein provided, if such record be required by law, shall in any manner be affected by such stamping as aforesaid.

Sec. 14. That hereafter no instrument, paper or document required by law to be stamped, which has been signed or issued without being duly stamped, or with a deficient stamp, nor any copy thereof, shall be recorded or admitted, or used as evidence in any court until a legal stamp or stamps, denoting the amount of tax, shall have been affixed thereto, as prescribed by law: * * *

Sec. 15. That it shall not be lawful to record or register any instrument, paper, or document required by law to be stamped unless a stamp or stamps

of the proper amount shall have been affixed and cancelled in the manner prescribed by law; and the record, registry, or transfer of any such instruments upon which the proper stamp or stamps aforesaid shall not have been affixed and cancelled as aforesaid shall not be used in evidence.

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